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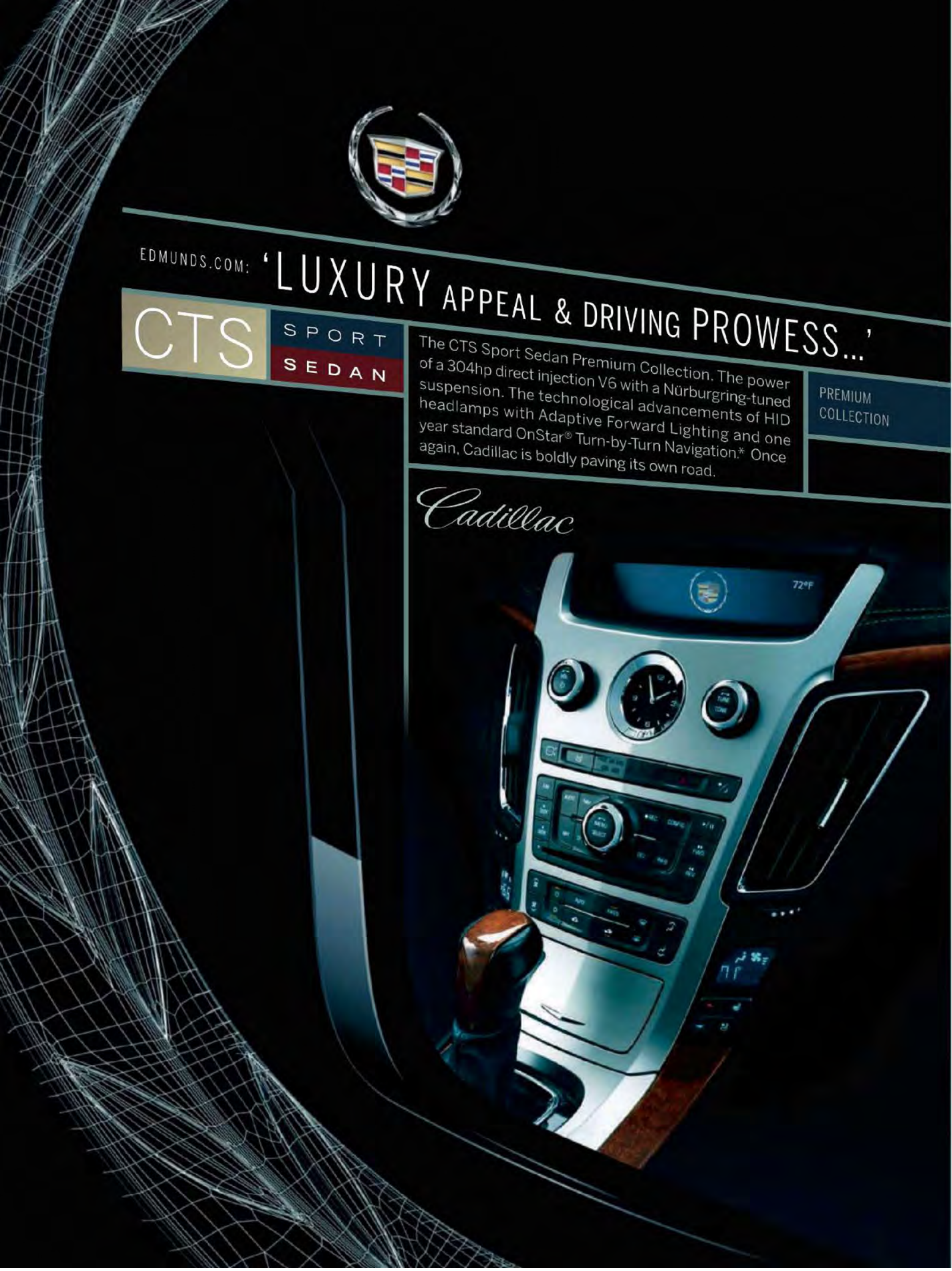
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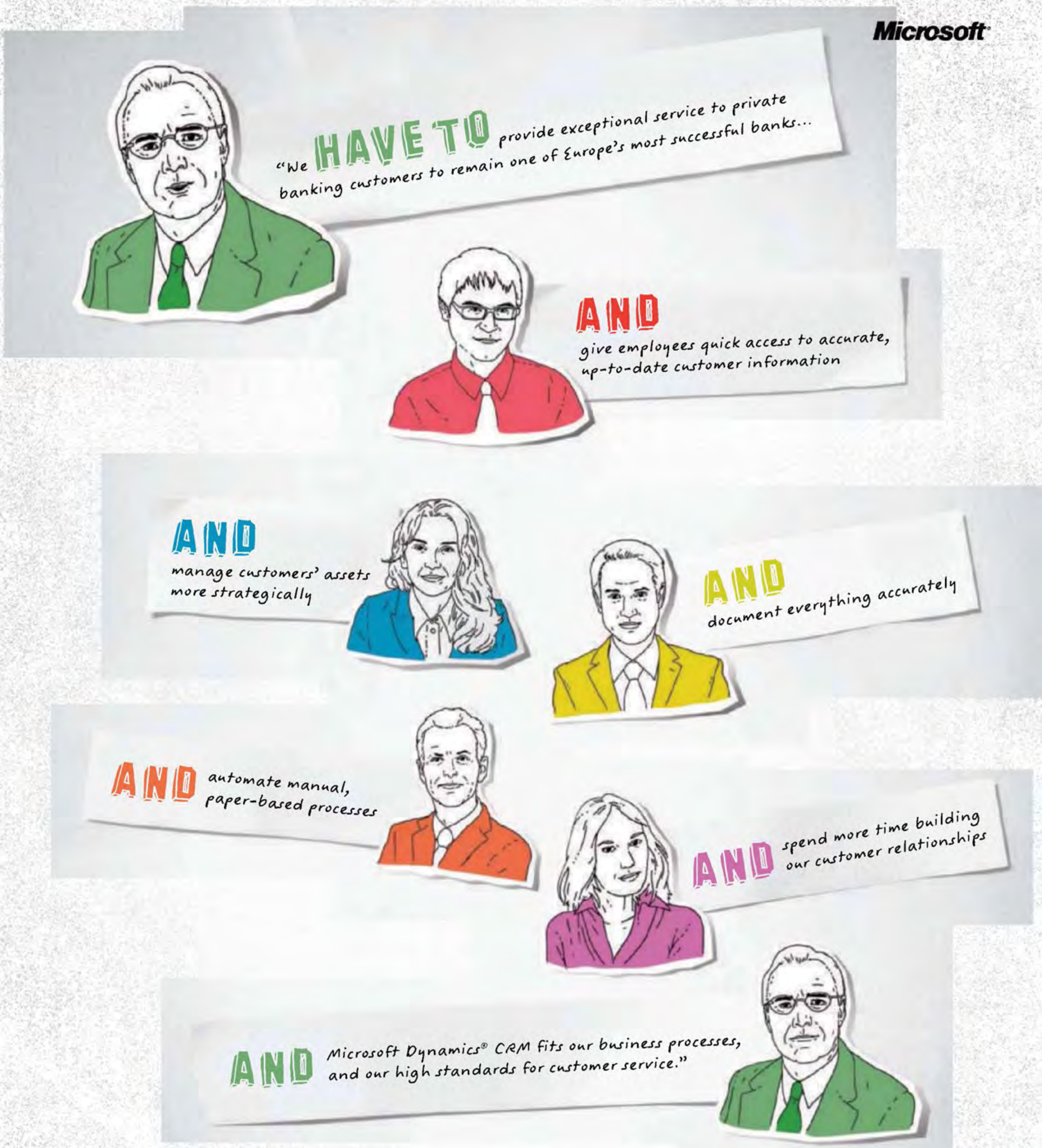


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COVER (AN UNIDENTIFIED SHIP MAKES ITS WAY THROUGH SPILLED CRUDE NEAR NEW ORLEANS): CHRIS GRAYTHEN/GETTY IMAGES
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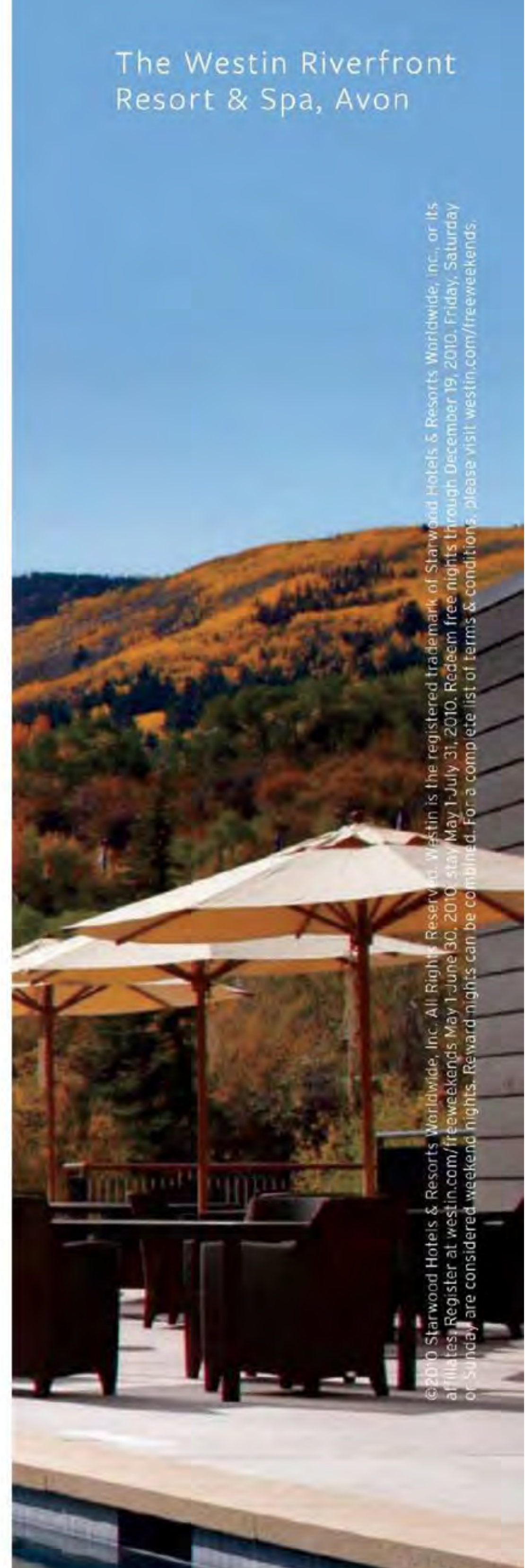
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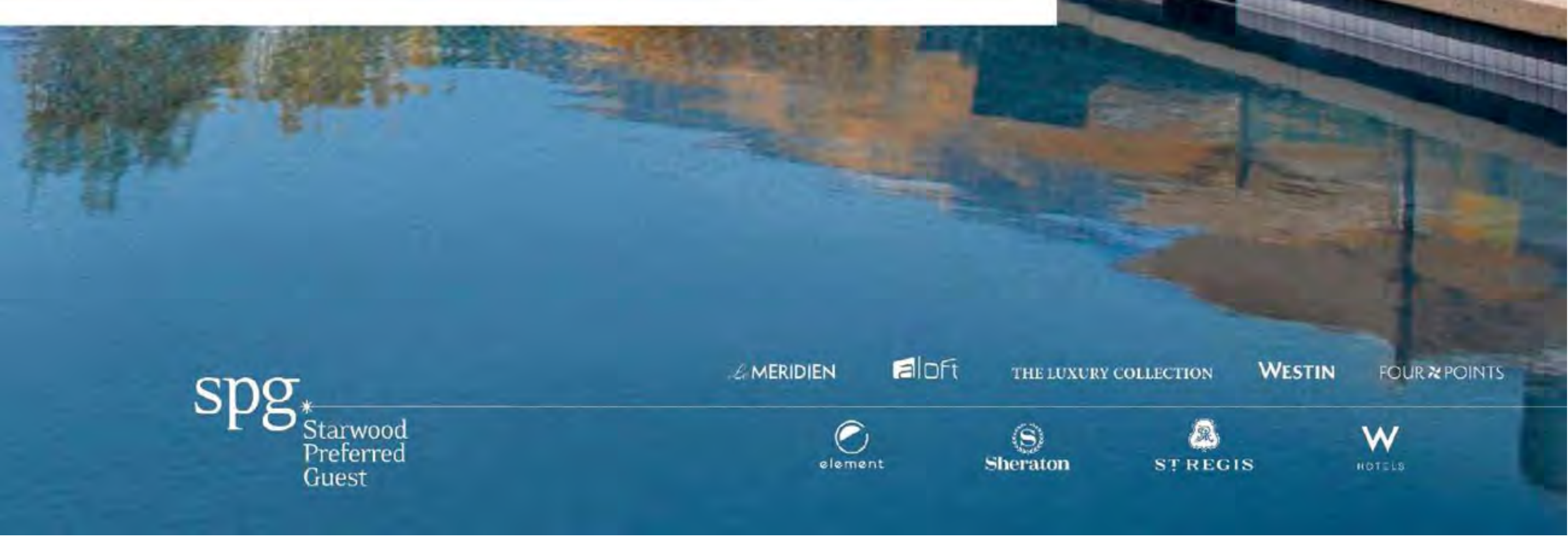
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Opening Remarks



Over the past decade, the airline industry has lost $60 billion and shed 160,000 jobs

TOM NAGY/GALLERYSTOCK

The Departed

A merger of United and Continental makes sense, but can it bring back the business of flying?
By Paul M. Barrett

On May 3, Continental Airlines Chief Executive Officer Jeff Smisek, a guy known for driving around Houston at 130 miles per hour (page 19), boasted how he'd telephoned his counterpart at United Airlines, Glenn Tilton, to break up the potential marriage of United and US Airways. "I gave Glenn a call and told him I was a much prettier girl," Smisek told Bloomberg News.

It would be unsporting to deny Smisek, 55, his Broadway turn as Maria in *West Side Story*. Yet the reality of the airline industry is anything but pretty. The vital function of flying passengers for work and pleasure remains a terrible business, and the merger of Continental and United won't do much to solve the problem.

Over the past decade, the domestic airline industry has amassed no less than $60 billion in red ink and shed 160,000 jobs, according to the Air Transport Assn., a Washington trade group. United and Continental each suffered losses for the past two years, and as borrowers they receive miserable credit ratings. On average, journeys between clogged airports take longer than they did years ago because of tarmac delays, circling before landing, and other factors, the ATA says.

Warren Buffett, as usual, has pithily summarized the situation. "You've got huge fixed costs, you've got strong labor unions, and you've got commodity pricing," he told *The Telegraph* back in 2002. Buffett learned his lesson after a disastrous investment in US Airways in 1989: "I have an 800 number now that I call if I get the urge to buy an airline stock," he said. "I call at two in the morning, and I say: 'My name is Warren, and I'm an aeroholic.' And they talk me down."

The one skill the carriers have consistently demonstrated, says Adam Epstein, a consultant and tech financier who flies frequently from his base in San Francisco, is using the Bankruptcy Code to rearrange their money-losing operations. Thirty-seven airlines, including United, have filed for Chapter 11 protection from creditors since 2000, according to the ATA; nine have been liquidated. "Maybe more should have just gone away, rather than reorganize," Epstein says.

Mergers are another way to thin a bloated industry, but the streamlining has been painfully slow and

Opening Remarks

"There are naive investors who refuse to believe that you cannot make good money delivering human beings over the surface of the planet."

Tom Petzinger, author, *Hard Landing*

uneven. The trouble with commercial air travel traces to 40 years of government fare and route regulation, which ended in 1978. Unable to compete on prices, the carriers tried to outdo each other on services. The complimentary booze flowed. Federal rules protected profits, so the companies had little incentive to contain costs. Salaries for pilots, flight attendants, and mechanics soared. Labor concessions in recent years have corrected some of the wage distortion, but not all of it.

In the 1980s and 1990s, upstarts such as Southwest Airlines challenged the longtime carriers, setting off intermittent price wars, strikes, and egotistical overexpansion. To this day, the industry hasn't gotten control of its crippling fixed costs. Even with sophisticated financial hedging techniques, it has suffered from high and volatile fuel prices. Freak storms, not to mention Icelandic volcanoes, can gouge millions from collective revenues.

After three decades of turbulence and the disappearance of PanAm, Eastern, TWA, and other hallowed brands, the airlines still have too many seats in the air. The dominant system of hub airports—Continental has them in Houston and Newark, N.J.; United in Chicago and Los Angeles—has proven to be expensive to maintain and prone to infuriating travel snags.

The only airlines that seem to have a winning formula are Southwest, JetBlue, and a handful of others that fly from point-to-point, keep expenses and fares low, and generally enjoy decent relations with their employees.

Though combining United and Continental makes plenty of sense on paper, history isn't encouraging. Most big airline mergers have yielded mediocre to poor results, not because the particular mix was a terrible idea, but because the entire business is hexed. US Air still juggles two sets of employees five years after merging with America West—and their lowly customer service ranking from J.D. Power & Associates reflects the confusion. The two lowest-rated full-fare carriers in the quality-assessment firm's 2009 survey were US Air and United. Delta Air Lines' 2008 hook-up with Northwest Airlines has gone more smoothly. The new Delta reported that it narrowed its loss in the first quarter to $256 million, down from $794 million in the quarter a year earlier. That passes for good news in the airline trade.

Given the alternative of struggling independently, United's deal with Continental seems smart, says Vicki Bryan, a senior analyst with GimmeCredit, a bond research firm in New York. Annual cost savings and new revenue could reach $1.2 billion by 2013, the companies project. They promise "improved profitability and sustainable long-term value for shareholders." The combined carrier should benefit from greater reach on the most lucrative international routes. "The airline industry has long been oversupplied, and that has kept air fares essentially unchanged for the past 20 years," says Bryan. "Without pricing power, there are only two ways that airlines can address this: higher-quality revenue [such as that from profit-rich routes to Asia and Europe] and lower costs." The United-Continental deal could produce both.



70s Style: Under regulation, airlines splurged on service and employees' wages soared

How much real consolidation occurs remains an open question. Seeking to buy peace with their unions, United and Continental emphasized that job reductions would be limited primarily to retirements and attrition. Some savings might come from further trims to amenities. Smisek, in his short four months as CEO of Continental, has curbed customer incidentals, which until recently were generous by air-travel standards. Catching up to its rivals, Continental has eliminated free food in economy class on most domestic flights. It also started charging extra for roomier exit-row seats and matching those annoying bag fees. "The merger looks like win-win for the two airlines," says consultant Epstein, "but I don't think passengers are going to feel better treated."

The modest-priced carriers notwithstanding, it's a mystery how the American airline business continues to attract capital with very little hope of a decent return. One explanation comes from Tom Petzinger Jr., who runs Launchcyte, a biotech-financing company in Pittsburgh. Earlier in his career, Petzinger wrote about airlines for *The Wall Street Journal* and in 1995 published a book on the topic called *Hard Landing*. "I hate to use the word 'romance,' in a business context," he says, "but I think that's what it is. There are naive investors who refuse to believe you cannot make good money delivering human beings over the surface of the planet. The assumption makes sense. The economic realities say otherwise. There are just too many other people with the same investment view, and too many planes flown by too many pilots.... The lesson keeps getting learned the hard way." Ⓑ

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Exports, including scrap metal, grew 14% in the last 12 months, but imports rose more

CHRISTOPHER GRIFFITH/GALLERY STOCK

Hooked On Imports Again

▶ **As the recovery takes hold, America's dependence on foreign goods is deepening**

▶ **The trade gap "doesn't seem to be a problem that's self-correcting"**

The U.S. trade deficit shrank like a puddle in the hot sun in 2008 and 2009 as appetite for imports melted in the recession and Asian export markets grew. WIth the U.S. economy now improving, the gap is widening again, dashing hopes that the U.S. is anywhere close to rebalancing trade with the rest of the world.

On Apr. 30 the Commerce Dept. announced that the economy grew at an estimated annual rate of 3.2 percent in the first three months of the year, propelled by stronger consumer spending and business investment. The bad news is that a lot of that consumption and investment went for imports. While exports grew at a 5.8 percent rate, imports grew at an annual rate of 8.9 percent. Overall, the trade deficit nicked 0.6 percentage points from the growth rate.

The broadest measure of the trade deficit peaked in 2006 at just over $800 billion, or 6 percent of gross domestic product. (These numbers describe the current account, which includes trade in goods and services as well as cross-border investment income.) By 2009 it was a little more than $400 billion, just under 3 percent of GDP. But by the second half of 2009, the gap had already come off its bottom—rising 18 percent from the second to the fourth quarter. "We would expect [the trade deficit] to grow a little bit faster than the overall economy," says Ethan Harris, chief economist at Bank of America Merrill Lynch.

The recession probably worsened the hollowing out of the economy, making it harder to balance trade

The quick resurgence shows that the recession didn't reduce U.S. overdependence on imports; by permanently closing many factories, it probably helped hollow out the U.S. economy, making it harder to balance trade. As **General Electric** Chief Executive Officer

Global Economics

Jeffrey Immelt said in a recent speech, China is likely to surpass the U.S. in manufacturing output in the next few years. "In Reagan's time, America was the world's biggest exporter by far," said Immelt. "Today, we're fourth."

The problem with a big trade deficit is that it adds to the debt of the U.S., already the world's biggest borrower. It also saps growth, because U.S. consumer demand is being met by foreign rather than domestic production. "Americans won't have jobs," says Peter Morici, a University of Maryland economist.

Industrial America's plight can be encapsulated in a few incredible numbers. According to the Bureau of Labor Statistics, U.S. employment in manufacturing over the past six months has been the lowest since March 1941, before the U.S. entered World War II. The March total was a little under 11.6 million workers, down 19 percent in just the past five years. Productivity advances account for some job reductions, but that's not the whole story: Manufacturing's share of GDP shrank from 25 percent in the 1960s to 15 percent in 2000 and just 11 percent in 2008, according to data from the Commerce Dept.'s Bureau of Economic Analysis.

Many of the most powerful U.S. manufacturers produce their goods for foreign customers in overseas locales, which does nothing to shrink the trade deficit. **General Motors** is going gangbusters in China, where it announced that it's on track to reach its target of 2 million annual vehicle sales four years ahead of schedule. Most of those GM cars, however, are made in the mainland. Likewise, **Eaton**, the Cleveland-based equipment maker, gets 55 percent of its sales outside the U.S. Spokeswoman Kelly Jasko says, "Our philosophy is to manufacture in the zone of currency."

18

PERCENT

Increase in the deficit in the U.S. current account, the broadest measure of trade, from the second to the fourth quarter of 2009

Quoted

"We're going to have an enormous [bank] consolidation. Canada is one-tenth our size, they have perhaps half a dozen banks. The U.S. has 8,000 banks, and of those a couple of hundred have already failed. There'll be hundreds more failures."
—Wilbur Ross, turnaround specialist



True, manufacturing is rebounding from its recession trough, and exports are growing. They rose 14 percent in the 12 months through February. David Huether, chief economist at the National Association of Manufacturers, says "the idea that we don't have the capacity to sell product overseas is off base" and predicts that trade is "going to be one of the durable bright spots for the next [few] years." Exports of scrap iron and steel have more than doubled from 2005 to 2009, with more than one-third going to China. On Apr. 26, **Caterpillar** announced a swing to a first-quarter profit from a year-earlier loss thanks to improved conditions, "particularly in the developing economies."

Still, brisk growth in China, India, and other Asian nations isn't triggering purchases of U.S. goods as strongly as it might. That's because much of the growth in Asian trade is within the region, says Frederic Neumann, co-head of Asian economics research for HSBC in Hong Kong. Europe, a more receptive market for the U.S., is weak.

Rising imports are the other culprit. Imports for the 12 months through February grew faster than exports, increasing 21 percent. In the first two months of 2010, the U.S. bought nearly $15 billion worth of advanced technology products such as computers from China, but sold China only $3 billion in high-tech goods, according to Commerce data.

Higher oil prices exacerbate the U.S. trade deficit. Yet even in volume, U.S. imports of all goods will grow nearly as much as exports this year, estimates Michael Englund, chief economist of Action Economics in Boulder, Colo. He concludes: "This [trade deficit] doesn't seem to be a problem that's entirely self-correcting." *—Peter Coy with Dexter Roberts, Shruti Singh, and Rachel Layne*

The bottom line *A large economy like the U.S. needs a manufacturing base to be an export power. That source of strength seems to be fading.*

Sovereign Debt

It's Portugal Against The Bond Traders

► **Lisbon gets no relief from the markets despite a Greek rescue**

► **"There were attacks by some international gangs"**

Since the start of the Greek crisis, bond investors have been eyeing Portugal as next in line for a bailout—if not default. As the Lisbon stock index sank (down more than 14 percent so far this year) and the credit default swaps market ranked Portuguese debt alongside that of Lebanon, Portuguese Prime Minister José Sócrates and his colleagues fought back, swearing that their country, one of the euro zone's poorest, would not go begging to Brussels. Finance Minister Fernando Teixeira dos Santos put it this way after Standard & Poor's Apr. 27 downgrade of Portuguese debt: "There are no reasons for markets to look at Portugal as they have been doing with Greece."

The markets have roundly repudiated that view. Many bondholders are now convinced that only a much larger program of fiscal austerity for the euro zone's vulnerable southern tier will reassure them. So just days after the Greek bailout, investors drove Portuguese stocks down almost 4 percent in one session: Yields on Portuguese two-year bonds topped 5 percent, way above the 1.3 percent they were yielding in January. The Portuguese reacted with

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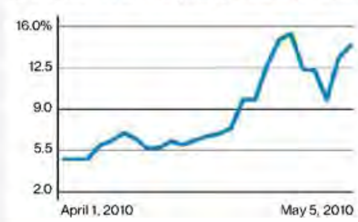
Greece

Investors Flee as Greece Erupts in Protests

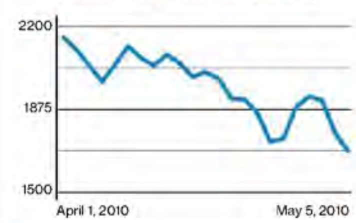


The three deaths in the Athens demonstrations marked an ugly turn in the battle over Europe's financial future. The demonstrators voiced loud opposition to the austerity measures Greece has to swallow before it receives $141 billion in aid from the European Union and the International Monetary Fund. Spooked by the uncertainty, investors fled Greek, Spanish, Portuguese, and other markets.

Spike in Bond Yields
(Yield on Greek two-year government bonds)



Plunge in Greek Stocks
(Athex Composite Share Index)



DATA: BLOOMBERG FINANCIAL MARKETS

dismay, blaming the excesses of naked capitalism. One politician, Francisco Louça, thundered about "attacks by international gangs."

Sócrates does not have a lot of cards to play. He points out, rightly, that Portugal did not fiddle its numbers the way the Greeks did and that Portugal's public debt, at 77 percent of gross domestic product, is lower than that of Greece and on a par with France. He and his ministers also successfully lowered the budget deficit in 2007 after spending spun out of control.

Investors, though, are not in a generous mood. Portugal's economy has grown less than 1 percent a year on average for the last decade. Its main advantage, cheap labor, gradually disappeared when it joined the pricey euro zone and wages kept rising. "We have seen a lot of multinational activity move away, and we have not been able to compensate," says Miguel Athayde Marques, chairman of Euronext Lisbon, the country's bourse. Labor costs have surged 3.4 percent a year, compared with 1.7 percent in Germany, and Portugal's productivity is the lowest in the euro region, according to the EU's statistics office.



Prime Minister Sócrates doesn't want a bailout. The markets may decide otherwise

As for Portuguese debt, throw in corporate and household obligations and you reach 236 percent of GDP, worse than Greece and Italy. The prospect of economic growth paying all that off is remote. "The reason we're concerned about Portugal is not because its public debts are especially high, it's more that the economy doesn't really grow," says Kenneth Wattret, chief euro region economist at BNP Paribas in London.

Portugal plans to raise as much as 25 billion euros this year to pay off earlier obligations. Luring buyers will be expensive. Yields of almost 6 percent on Portuguese 10-year bonds are nearly three percentage points higher than German bonds. Investors are trying to avoid being ambushed by the "next Greece," says Olaf Penninga, who helps manage $187 billion at **Robeco Group,** a Rotterdam-based asset manager.

Portugal's savings rate, at 10 percent, is the fourth-lowest among 27 members of the Organization for

Global Economics



The return of impulse buys for snacks
page 23 ►

Economic Cooperation & Development, according to the Paris-based group's data. Low savings have fostered a dangerous dependence on foreigners to fund the deficit.

Sócrates, a Socialist, has been running a government without a parliamentary majority since his reelection in September, making it harder to push through unpopular legislation. "We face tough times," says Filipe de Botton, co-chief executive officer of **Logoplaste,** a maker of plastic packaging headquartered near Lisbon. "The government will have to lower salaries in the public sector. We will probably have to increase taxes."

Before adopting the euro, Portugal could devalue its currency to boost competitiveness. That option no longer exists. Instead, it has to restructure its debt, says Stuart Thomson, who helps oversee $100 billion at **Ignis Asset Management** in Glasgow. Debt restructuring, explains Thomson, "is the new currency devaluation in the euro zone." —*Emma Ross-Thomas and Jim Silver*

The bottom line *The real issue is competitiveness. Portugal needs better-educated workers and looser labor rules to attract multinationals.*

Unemployment

The Best Places To Lose Your Job

► The Norwegian government is especially generous

► "The lack of money is a big incentive to get back to work"

No one likes to lose a job, but the unemployment benefits in some countries definitely make the bad news a little less bad. Take oil-rich Norway, where unemployment is 3.3 percent. Thanks to state support, laid-off workers pocket 72 percent of their annual net salary, or $56,940 on average in combined unemployment pay and state benefits, vs. just 28 percent in the U.S., according to the Organization for Economic Cooperation & Development (table). Germany offers vocational training, including a full-size "fake" supermarket in Hamburg where the unemployed practice working at a checkout. The German government also pays one-third of the salaries of workers whose hours and wages are slashed by up to 50 percent—as long as companies keep those employees on the payroll. And in recession-hit Spain, policymakers launched a two-year, $226 million program in late 2008 that includes paying down workers' mortgages until they find jobs. "Governments want to ensure people don't fall through the cracks," says Paul Swaim, a senior economist at the OECD in Paris.

At some point, fiscal reality may force policymakers to trim benefits. That means cutting back the handouts that can discourage people from looking for jobs. In Japan, with 4.9 percent unemployment, the government gives salarymen 45 percent of their net pay during the first year of unemployment, and just 3 percent if they haven't found work in 12 months. (Some 67 percent of jobless do.) Lower benefits compel many jobless workers to take any job. Says Edward Drury, a 29-year-old telecom salesman in London who has lived on $400 a month in unemployment pay since March: "The lack of money is a big incentive to get back to work." —*Mark Scott*

The bottom line *Europe still offers the most generous unemployment benefits, but handouts may be cut as governments slash budget deficits.*



The average French auto worker would earn over $25,000 in the first year if terminated

Unemployment

Jobless Pay Around the Globe

European governments offer the highest percentage of combined unemployment pay and state benefits, while the U.S. provides the least generous compensation to dismissed workers.

Country	Norway	Spain	France	Germany	Canada	Turkey	Japan	South Korea	U.K.	U.S.
Unemployment rate*	3.3	19	10.1	7.5	8.2	14.5	4.9	4.4	8	9.7
Unemployment benefit in first year**	72%	69%	67%	64%	52%	46%	45%	31%	28%	28%
Benefit after 12 months	72	65	64	48	14	0	3	0	28	0***

*FEBRUARY 2010 **PERCENT OF ANNUAL INCOME ***UNDER OBAMA ADMINISTRATION, BENEFITS EXTENDED TO 99 WEEKS FOR SOME CLAIMANTS
DATA: ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT, U.K. OFFICE OF NATIONAL STATISTICS, TURKEY'S STATISTICAL BOARD

AUTO WORKER: LUCAS SCHIFFRES/BLOOMBERG/GETTY IMAGES

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Capital

With Recession Over, Bubbles Start Forming

▶ Investors are bidding up prices in Asia, Australia, Latin America

▶ The IMF issues a warning. Some economists predict a China crash

The International Monetary Fund took time out from rescuing Greece in late April to warn the world about asset bubbles—those eruptions of speculative buying that hit economies from time to time and that usually end badly. The biggest bubble in recent times was the subprime-fueled housing boom in the U.S. Yet many economists think China could still win the bubble sweepstakes with its surge in property prices, huge trading imbalance, and record inflows of investment capital. The IMF also sees "hot money"—flows of foreign capital that move in and out of markets with a few keystrokes—threatening stability in currency rates, stock values, and real estate prices worldwide. One interesting trend: Many of the possible bubble economies have deep trade connections to China. Below is *Bloomberg Businessweek*'s quick guide to possible bubbles in the making. —*Christopher Power*

The bottom line *The deepest fears are about a China bubble where the central bank may not have all the policy tools it needs to stop a disaster.*

Microfinance

An IPO for India's Top Lender to the Poor

▶ Critics say investors, not poor customers, will reap the benefits

▶ "There is soul-searching in the microfinance industry now"

For years, advocates for the poor have promoted microfinance—small loans for entrepreneurs in the rural areas of Latin America, Africa, and Asia. In 2006, Muhammad Yunus and his **Grameen Bank** won the Nobel Peace Prize for popularizing the idea. Now businessman Vikram Akula is betting that microfinance is good for investors, too.

Akula, an ex-**McKinsey & Co.** consultant, is founder and chairman of **SKS Microfinance,** India's largest microlender. It recently filed to raise up to $250 million in an initial public offering to be listed on the Bombay Stock Exchange and the National Stock Exchange of India. SKS will be the first Indian microfinance lender to go public. Among its backers are venture capital firm **Sequoia Capital** and **Catamaran Management Services,** a fund run by N.R. Narayana Murthy, co-founder of outsourcing giant **Infosys**.

The prospectus reports that SKS earned $18 million in the fiscal year ending March 2009 on a loan portfolio of $320 million. For first-time borrowers, SKS lends amounts of $20 to $260

Capital

Possible Overheating



Canada: It weathered the crisis. Now housing has taken off—and is generating an alarmingly high portion of GDP growth.

Brazil: Foreign capital is pouring in. Expected growth of 5.8% is brisk. Some analysts fear the government will overspend to influence the October election.

India: Two things to watch out for: Inflation is approaching 15%, and foreign investment in Indian stocks and bonds is at an all-time high of $92 billion.

Australia: A toss-up. The mining sector is white-hot and housing prices have jumped, but the central bank is hitting the brakes.

South Korea: A surprise bubble. Growth is approaching 5% and the central bank has kept rates too low, say analysts. Household debt is dangerously high.

China: GDP and property prices both increased more than 11% in the first quarter. The central bank keeps tightening, with little to show for it.

ILLUSTRATION BY MIKE SMITH/LAS VEGAS SUN/KING FEATURES SYNDICATE; OPPOSITE (FROM TOP): ZACKARY CANEPARI; ANDREW HARRER/BLOOMBERG



Akula, chairman of microfinance lender SKS, with a client, who used her loan to buy a spice grinder

at annual interest rates of 26.7 percent to 31.4 percent. Akula declined to comment, citing the quiet period ahead of the IPO, which will be managed by **Citigroup, Credit Suisse,** and local bank **Kotak Mahindra.**

In India, microlending grew at an estimated 45 percent clip in the year ended March 2010, according to Micro-Credit Ratings International in Gurgaon, India. The World Bank's International Finance Corp., which helps private companies, has invested a total of $1.3 billion in microfinance firms. "It's a big business," says Matthew Gamser, principal of IFC advisory services in Hong Kong.

Not everyone is happy about that. "There is soul-searching in the microfinance industry now," says Jennifer Meehan, Asia chief executive officer for the Grameen Foundation. "When the headline becomes 'Foreign Commercial Investors Making Money from the Poor,' that worries those of us who care about microfinance as a way to move people out of poverty." Critics point to **Banco Compartamos,** the Mexican microlender that raised $467 million in a 2007 IPO. The bank, which activists claim lends at excessively high interest rates, saw its stock price double over the past year and its market cap hit $2.5 billion. (A Compartamos spokesman says the bank has 1.5 million clients and $633 million in outstanding loans, which average $450. It charges average annual interest of 68%.)

SKS's IPO, expected this summer, has largely escaped criticism. Industry pioneers expect more such offerings if the IPO succeeds, and some worry the pressure to boost profits will push microlenders away from their traditional customers. Says David S. Gibbons, chairman of **Cashpor,** a microlender in Varanasi, India: "The danger is the poor will be left out."

—Bruce Einhorn, with Ruth David

The bottom line *SKS's IPO may trigger a spate of public offerings in microfinance. How much the poor will be helped is a subject of debate.*

Tom Keene's EconoChat

Tom talks with **Mohamed El-Erian,** CEO of bond investor PIMCO, about the Greek crisis and its effect on the U.S. dollar

What has to happen to resolve the Greek crisis?
EL-ERIAN: The Greek government [must] sell to the population the need for a sustained adjustment. The Europeans [must] decide once and for all that they are willing to put in new money in a very aggressive fashion. You need the IMF to be the credible conductor of what is a hard process. And you need the markets to calm down. Why do the markets bring out more sellers when Greek bond prices go down? Because investors have woken up to the fact that they're not dealing [simply] with interest rate risk, they're dealing with volatile credit risk that's exposing them to losses and reputational damage.

What do we need to see from Greece's Prime Minister?
An ability to convince Greek society that this is a long-term process in their interests. You remember Korea. [South Korea had a sovereign debt crisis in 1997.] In Korea, the citizens came together and supported the adjustment process. So far the Greek government has not been able to do that.

Does this spread?
It's spreading to other European countries. Where it's not spreading is globally. Short-term, the U.S. benefits. As my colleague Paul McCulley says, "Sometimes you find your cleaner shirt, but sometimes you end up [getting] your cleanest dirty shirt." Despite the issues in the U.S., the U.S. is benefiting from a flight to quality.



Keene hosts Bloomberg on the Economy *at 11:30 a.m. DST on XM 129 and Sirius 130.*

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United and Continental Reach for the Sky

▶ By forming the world's largest airline, the carriers make a big bet on scale

▶ "U.S. aviation history is littered with the debris of airline mergers"

The future chief executive officer of what's likely to become the world's biggest airline surprised his old boss one night on a Houston highway by pulling alongside in his Infiniti as they were each clocking about 130 miles per hour.

"The passenger window goes down, and there's Jeff, a big grin on his face," former **Continental Airlines** CEO Gordon Bethune, 68, says in recalling the late-1990s episode involving Jeff Smisek, then the carrier's general counsel. "He waves at me and takes off. Who else would do that?"

Obviously, Smisek likes taking risks, whether it's racing on a darkened highway or piloting a combined Continental and UAL's **United Airlines** after their $2.9 billion merger. Yet the 55-year-old Harvard Law School graduate, who has been at Continental's controls only since January, is trying to rewrite the rules of an industry that has humbled plenty of other CEOs before him. "We fully expect that Smisek and his team will be successful in combining the best of each organization," said Douglas Runte, managing director of Piper Jaffray. "But the immensity of the challenges should not be underestimated. U.S. aviation history is littered with the debris of airline mergers."

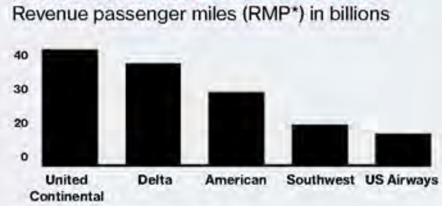
How's this for a to-do list: Smisek will have to figure out a way to generate profits at the combined carrier after annual losses at UAL and Continental in each of the past two years; navigate a tough U.S. antitrust review; and work with restive unions that had demanded the ouster of United CEO Glenn Tilton, who is staying on as nonexecutive chairman of the combined carrier.

Key to Smisek's success will be his ability to realize $1.2 billion in combined cost savings and new revenue, while funneling additional traffic from the expanded United-Continental domestic network into its more lucrative international routes.

Just managing the sheer logistics of the combined airlines will be a huge undertaking. The main jet fleets of the two carriers total 700 aircraft. Continental flies only **Boeing** planes; United uses jets from both Boeing and **Airbus**. Flying planes from different makers requires separate maintenance procedures, staff training, and spare parts.

The combined airlines, which will operate under the United name but sport Continental's colors

United-Continental Would Rule the Skies
Revenue passenger miles (RMP*) in billions



*RPM, the standard metric for airline traffic, equals one paying passenger traveling one mile.

HIROKO MASUIKE/GETTY IMAGES

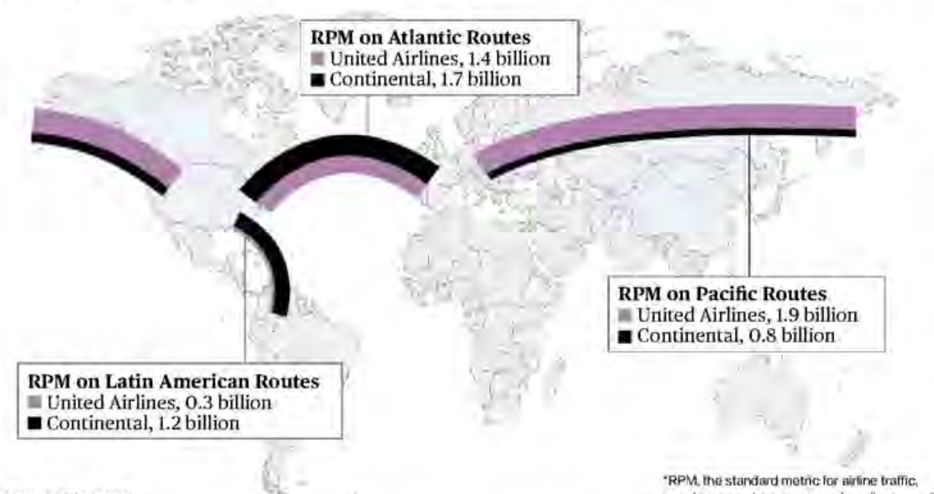
Companies



A candidate with a pro-Wall Street agenda page 26 ▶

United-Continental's Push for Global Dominance

By merging Pacific routes where United leads with Continental's big Latin presence, the new carrier will be a global power. The colored lines represent each carrier's international traffic, measured in revenue passenger miles (RPM*). The thickness shows the proportional relationship between the two airlines.



DATA: BLOOMBERG

*RPM, the standard metric for airline traffic, equals one paying passenger traveling one mile.

and globe logo, now employ more than 88,000 workers. Other than some white-collar consolidation, management so far says it isn't planning big staff cuts. Yet it still could face tough negotiations with its airline unions, often a major impediment to a successful merger.

Traditionally the key task has been harmonizing work rules and consolidating union seniority lists into a single worker roster. Since seniority determines which pilots get higher-paying aircraft assignments and better working hours, it's usually a traumatic process. US Airways, for instance, still has not been able to get workers to agree to unified contracts–five years after its merger with America West. Maintaining two sets of work rules has kept US Airways from realizing some of the planned savings behind that tie-up.



Predecessor companies of both United and Continental were started by 1920s air pioneer Walter Varney

Frequent flyers shouldn't encounter any hassles. Continental's OnePass and United's Mileage Plus rewards programs will not be merged until after the deal is completed, which could be as soon as late 2010. Then, account balances from the two programs would be combined. The Continental and United reward programs already are linked through the Star Alliance of international carriers, so there will not be a big increase in reward destinations due to the merger.

Things won't go nearly so smoothly for Smisek, who must convince regulators that the Continental-United marriage would not significantly reduce competition. Currently, United is the third-biggest American carrier by traffic (Continental is No. 4) behind Delta Air Lines and American Airlines. The combined airline would leap to the front of the tarmac, raising fears that it could amass too much pricing power–especially on high-fare international routes frequented by business travelers.

A United-Continental combination would surpass Delta as the top U.S. carrier on routes across the Atlantic with a 40 percent share of passenger traffic. The duo would handle 53 percent of all traffic on Pacific routes (United is the leader now), based on data compiled by Bloomberg. In the U.S., the two airlines have overlapping nonstop flights in 13 markets.

True, U.S. antitrust authorities have allowed lots of industry consolidation in recent years. Washington approved the 2008 merger of **Delta** and **Northwest** and **US Airways Group**'s merger with America West Holdings in 2005. That was during the Bush Administration. The Obama Administration Justice Dept.'s antitrust division led by Christine Varney is another matter. She's expected to scrutinize the Continental-United tie-up closely. Varney has already raised questions about the competitive impact of existing international airline alliances that share some flights but stop short of mergers. Last June, DOJ called for limits on Continental's earlier request to coordinate flights overseas with United, saying the plan was "unprecedented in scope and breadth, sanctioning collusion."

The department "signaled quite strongly, in my view, that it would be very skeptical of a complete merger between United and Continental," said Mark Popofsky, co-head of antitrust at Ropes & Gray in Washington and a senior counsel in President Bill Clinton's Justice Dept.

United and Continental downplay worries about air pricing, noting discount carriers now command more than a quarter of domestic traffic. "This is a brutally competitive industry," Smisek said after the deal was announced. "We couldn't set airfares before this, we can't set airfares after this. We are responsive to demand."

Still, some industry insiders believe regulators may force route divestitures or the sale of some of United and Continental's takeoff and landing slots at coveted airports in the New York and Washington areas. Says James Burnley, a partner at Venable in Washington and U.S. transportation secretary under President Ronald Reagan: "It's by no means going to get automatic approval." —*Mary Schlangenstein, Mary Jane Credeur, John Hughes, and Jeff Bliss*

The bottom line *A merged United-Continental must assuage competition regulators without losing scale advantages that make their marriage attractive.*

Quoted

"We see a pile-up of inventory at dealerships and actually a decline in transaction prices. When you have too much inventory on the ground, you have to put cash in the trunk."



—Finbarr O'Neill, president of JD Power & Associates, on the possibility that automakers in China will begin offering incentives to sell cars.

Charlie Rose talks to

Jimmy Lee



Storied dealmaker James B. "Jimmy" Lee Jr. of JPMorgan Chase helped engineer the United-Continental merger. He sees an M&A wave of major proportions just ahead

BILL LYONS/ADMEDIA/SIPA PRESS

How did this deal happen?
The seeds were planted quite some time ago–in 2006 or 2007–when Glenn [Tilton, United chief executive officer], who has been vocal about consolidation, initiated conversations with a handful of airline CEOs. It was clear then that United and Continental were extremely complementary ... and you could easily envision a merger of equals. We negotiated the entire transaction for United, and then on the eve of announcement, [Continental CEO] Larry Kellner and his board pulled out. In 2009, we entered into detailed discussions with US Airways, and word of that leaked out several weeks ago. Jeff Smisek, who is Kellner's successor, then called Glenn and said, "Would you be amenable to sitting down again?" and they did. The United board was quite worried that Continental would [back out a second time]. But the deal executed last Sunday night was virtually the same transaction we negotiated two years ago.

So one deal blows up in 2008 because Continental got cold feet. Then you're off to make another one with US Airways. At the same time, are you looking for other partners?
Yes, because when you're working on mergers of this magnitude you have to have a Plan B. It's not that we didn't want to do the US Air deal; we were highly engaged, and we were going to do it. And had everything stayed confidential and so on, we probably would have done it.

Why is this merger good for the employees of the two companies? Why is it good for airline customers? Why is big better?
Big by itself isn't better, but big in this case will be better, assuming the management teams execute. The synergies that this combined company will be able to achieve, in both revenue and costs, will give it much better access to credit and equity markets. Airlines are constantly on the ropes–and in some cases in and out of bankruptcy–because their balance sheets are far too leveraged for their business. You've heard Jamie Dimon talk about a "fortress balance sheet." That's what an airline needs. I mean, your cost of fuel is out of your control; weather's out of your control; you've got these big, expensive machines that you have to constantly buy and replace. And unfortunately in our world, there are terrorist threats. It's a very, very difficult business to run because of the volatility. So you need a big, strong, high-investment-grade balance sheet, and that's what this company's going to get. Why is it going to be good for employees and customers? Because this new company will be able to ride through the toughest storms.

Do you see antitrust implications on the horizon for this deal?
You know a lot of these deals have not been tested under this new Administration. On the one hand, you might say, "Well, jeez, Delta-Northwest passed through." But it's not clear what this Administration is going to say. Right now, the NBC-Comcast transaction is being reviewed. And then, of course, the Continental-United deal will be reviewed. Everyone is hopeful that these transactions will get passed. But you don't know until you know.

You also worked on the GE/NBC-Comcast deal. Is this the start of a new M&A wave? What's going on?
It's a handful of things. No. 1, CEO confidence is now becoming restored. Most CEOs feel that we're turning a corner in the economy. No. 2, the credit markets and the equity markets are wide open. Technically very strong, very sound, plenty of capital. No. 3, the cost of capital is still extremely low. You know, we sold $4 billion worth of bonds for the new NBC last week, and the average cost was 5.11 percent per annum.

And companies are sitting on cash.
Exactly right. That was going to be my last point. Right now in the U.S., there's a trillion dollars on corporate balance sheets, which if you adjust for time is the most that's been on balance sheets since 1952. That money is earning almost zero. And I think one of the features of this wave of M&A activity will be very large transactions. That's my instinct. We'll see if that's true. But NBC was a $30 billion transaction.

We'll see deals exceeding that?
I think so. I really do. All the traditional signs are in place for a very large merger boom.

In what sectors?
One sector where there hasn't been a lot of M&A but there is so much cash and new opportunities is tech. I wouldn't be surprised to see transactions anywhere from $5 billion all the way up to $40 billion in that space.



Watch Charlie Rose on Bloomberg TV weeknights at 8 p.m. and 10 p.m.

Speed Dial

Nitin Nohria

On May 4, Harvard tapped a prolific leadership and ethics scholar as the next dean of its business school. His thoughts on the state of American business

What does it mean to take on this role after the global economic crisis?
Business itself is at an inflection point. Society's trust in business has certainly been shaken. As a result, some of society's trust in business education has been shaken as well. My hope at Harvard Business School is to restore that trust in business and business education. What we have to ask ourselves as business leaders and as a school is what can we do to restore this trust that has been lost so widely. I believe this trust can be repaired.

What's the common thread running through the current raft of business scandals?
Not all of this is about ethics. It's a broader thing. There's something about the way that we began to run business that made the pursuit of short-term profit maximization more important than creating long-term sustainable businesses.

Have you watched the congressional hearings on Goldman Sachs?
The events in the financial sector are something that have been watched closely at Harvard Business School. We teach by the case method, and one of the things we'll do through this experience is study these cases deeply as information is revealed over time so we can understand what happened at all these financial firms. I'm sure that at some point we'll write cases about Goldman Sachs because that's how we learn.

How do you feel about being the first Indian-born dean of the business school?
Like so many immigrants to America, I'm proud of my heritage, but I'm also an American citizen. I certainly think that the fact that I lived half my life in India and now half my life in the U.S. and have traveled all over the world allows me to bring a global perspective that's quite valuable to the school at this stage in its history.

What sense do you get from students about the direction they would like to see the business school go in?
There's a lot of energy about the economic crisis and the sense of lost trust. Students care equally about other things. Students want to make sure the faculty they have are bringing to them the best ideas in the world. They care about our environment being a place where they can thrive and learn.

What difference can a business school make in addressing these challenges?
What we have to do as a school is usher in what I think of as a new century of innovation, to really remake business education. We need to restore confidence that we can continue to educate leaders with the competence and character to fulfill their positions of power and privilege. B *—John Lauerman*



Mission ▸ **Restoring trust in business school education**
Output ▸ **Prodigious: He has written 12 books on management**
Education ▸ **PhD in management from MIT's Sloan School of Management**

Health Care

Getting Patients to Pay Before They Go Home



▸ **Software can predict who will pay, and help them figure out how**

▸ **"How do you [care for the poor] and still have a sustainable ministry?"**

Even the Sisters of Charity sometimes need help collecting bills. That's where **Conifer Health Solutions** comes in. Conifer is among a handful of software companies that hospitals, like those run by the Catholic order, hire to collect payments from patients. The goal: to catch patients before they leave the hospital and eliminate collection headaches down the road.

Conifer, a unit of **Tenet Healthcare**, and **Accretive Health** focus on collecting from "self-pay" hospital patients who make too much to qualify for charity care. In elective procedure cases, the companies may ask patients to fill out questionnaires. These provide data for software that assesses health and life insurance policies, income, credit reports, house ownership, even memberships in groups that may offer supplemental coverage, and helps determine how likely patients are to pay.

Self-pay patients are the biggest source of rising levels of bad debt at hospitals, said Milton Silva-Craig, executive vice-president of **TransUnion**'s health-care business unit. Many may have lost insurance coverage after a layoff or have an increasingly popular type of health plan with lower premiums but high deductibles of $1,200 or more.

"We know that 30 percent of the population won't pay because they can't afford to, and 30 percent will pay," said Stephen Mooney, president of Conifer's Revenue Cycle Solutions unit in Frisco, Tex. His company aims to identify the remaining 40 percent

NOHRIA: MIKE FEIN/BLOOMBERG

who have some assets but need help figuring out whether and how they can afford their bill.

One measure of Conifer's success is the portion of patients' out-of-pocket costs, such as deductibles, that are collected before they leave the hospital or clinic, when administrators can still deal with them face-to-face. According to Tenet, about 38 percent of the total cash collected in 2009 by hospitals it owns was received at the time of service, up nearly one-third, from 29 percent, in 2006, when it started using Conifer's system.

This type of software also helps people find ways to pay, says James Connelly, chief financial officer of the Henry Ford Health System in Detroit (photo: main building). When a patient decided to forgo an elective procedure recently because he couldn't pay the $100,000 cost, Accretive's software discovered a medical codicil in the patient's life insurance policy that "never would have surfaced by pure chance," Connelly said. The codicil ended up covering much of the cost, he said.

Stories like that are answered prayers for many hospitals, especially those pinched by losses on charity care. "One of our main values is to take care of the poor and vulnerable," says Mary Jo Gregory, chief operating officer of Sisters of Charity of Leavenworth Health System, which operates 11 hospitals west of the Mississippi and is using Conifer software. "How do you fulfill that role and still have a sustainable ministry? Our bad debt is high, and we're facing the same issues as everyone else in terms of collections." *—David Olmos*

The bottom line *For hospitals, talking to patients upfront about fees means they can recoup more. Data mining provides the information to do that.*

Drawing Board



ILLUSTRATION BY ENGLEHART/THE HARTFORD COURANT/CAGLE CARTOONS



Consumer Spending

Slurping Toward an Economic Recovery

▶ **Impulse buys of snacks and sodas are back at convenience stores**

▶ **Hershey's CEO: "We saw volume in convenience return in a big way"**

Here's a little sugar buzz for the American economy: Impulse purchases of sodas and Hershey bars have finally started to swing upward at U.S. convenience stores after a dismal performance in 2009.

PepsiCo and **Coca-Cola** say the decline in sales at convenience stores slowed last quarter for the first time in at least a year. **Hershey's** first-quarter chocolate, mint, and gum sales in those stores grew about 6 percent. "We're definitely seeing improving trends," says Dennis Phelps, senior director of beverages for 7-Eleven, the world's largest convenience retailer. Sales (excluding cigarettes) at U.S. convenience stores rose 0.5 percent in March after a 1.3 percent decline during the previous 52 weeks, according to Consumer Edge Research.

The uptick in junk food consumption may not thrill nutritionists, but it's further confirmation of a rebound in consumer spending. U.S. retail sales increased 1.6 percent in March, more than anticipated by economists and the biggest gain in four months, according to Commerce Dept. figures. Meanwhile, the Conference Board's consumer confidence index jumped to 57.9 in April, the highest level since September 2008.

All this is lifting the outlook for food companies. "We really saw volume in convenience return in a big way," Hershey Chief Executive Officer David J. West said on an Apr. 22 conference call. Half of convenience store purchases are on impulse, he said. Convenience stores accounted for 13 percent, or about $590 million, of the $4.5 billion in U.S. sales Hershey raked in last year. "Encouraging" sales of beverages at U.S. convenience stores continued into the second quarter, Eric J. Foss, head of PepsiCo's bottling unit, said on Apr. 22. Coca-Cola also saw slight improvement at convenience stores, says Dana Bolden, a spokesman for the Atlanta-based company.

In April, packaged beverages "will probably have one of the best months we've had in over a year," says 7-Eleven's Phelps. "There's no question about it, we're seeing better sales," adds Mike Thornbrugh, a spokesman for closely held **QuikTrip**, the Tulsa-based operator of 548 convenience stores. "It's not as much as we'd like, but they're still spending."

Snacks, too, showed signs of recovery in the first quarter, says John Compton, CEO of **PepsiCo Americas Foods** , an arm of Purchase (N.Y.)-based PepsiCo, the world's biggest snack maker. "I would characterize it as improving," he said during the call. "It has a ways to go as the unemployment numbers need to improve." *—Duane D. Stanford*

The bottom line *It will take more than a spike in Snicker sales to pull off a consumer recovery. Still, this is encouraging data.*

Autos

With Lincoln, Ford Isn't In the Lap of Luxury

▶ **After its sale of Land Rover, Jaguar, and Volvo, Ford banks on Lincoln**

▶ **"To younger generations, that's grandpa's car"**

Business is booming in Jack Kain's Ford dealership in London, Ky. Not so much, though, at his Lincoln showroom, where new models like the hulking MKT wagon go begging for buyers. "It would be very, very tough for us to make it if we just had Lincoln," says Kain, who owns two Ford stores and one Lincoln outlet in Kentucky horse country.

Ford is on a roll, as mainstream car buyers embrace the American brand that didn't go bankrupt. Now that Chief Executive Officer Alan Mulally is unloading **Volvo**, however, Ford's upscale ambitions are riding on Lincoln.

Companies

Sales at the unit are down 64% from its 1990 peak and buyers average an industry-high age of 62, according to **J.D. Power and Associates**. "To younger generations, that's grandpa's car," says auto analyst Jesse Toprak of researcher TrueCar, "That doesn't help when you're going up against **Mercedes** and **BMW**."

Ford is trying to give Lincoln a hip implant. It's outfitted four new models with more-dramatic design and installed high-tech features including a voice-activated phone and entertainment system. To boost sales, Ford last week gave Lincoln its own marketing manager for the first time in nearly two years.

The new look isn't helping much. Lincoln's U.S. market share is stuck at a paltry 0.8% this year, while the Ford nameplate grew at its fastest rate since 1977. Lincoln isn't even outselling the Mercury brand, which Ford is starving of new models and marketing. Lincoln is still defined by the black Town Car that has ferried generations of business travelers to the airport, says analyst John Wolkonowicz of IHS Global Insight. "Ford doesn't have a true luxury brand anymore," he says. "All the Lincolns are nothing more than gussied-up Fords."

Ford long ignored Lincoln, in part because over the last two decades it bought a stable of European luxury brands that seemed to hold more potential: Jaguar, Land Rover, Aston Martin, and Volvo. But shortly after arriving from Boeing in late 2006, Mulally began dismantling what he called Ford's "house of brands," selling off the European lines at fire sale prices. The idea was to first fix its largest franchise, the middle-market Ford brand, which had become so dependent on sales of big SUVs and pickup trucks that the automaker lost $30 billion from 2006 through 2008. Lincoln, whose models are based on Ford's mechanical platforms and built in Ford plants, would be kept and fixed later.



CEO Mulally began dumping Ford's European luxury brands shortly after his arrival

Lincoln is sold only in North America. That leaves Ford at a disadvantage to other major automakers, which take luxury lines global as a source of prestige—and profits. The cache of an international luxury brand can command margins more than twice those of mainstream models. That's why Germany's **Volkswagen** sells Audi cars worldwide and Japan's **Toyota** has built Lexus into the top-selling U.S. premium line. Even post-bankruptcy **General Motors** is making a renewed push into Europe, Russia, and China with Cadillac.

Taking a luxury brand abroad also lets automakers tap faster-growing foreign markets. That's why TrueCar's Toprak thinks Ford is "leaving money on the table" by not taking Lincoln overseas. "They really need a global luxury brand because 80% of the growth in vehicle sales in the next five years will come from outside the U.S.," he says.

Still, Ford thinks it has good reason to keep Lincoln at home: "Our track record operating global premium brands has not been stellar," says Chief Financial Officer Lewis Booth.

Ford is retiring the Town Car next year and launching new models aimed at younger buyers like the MKX sport wagon this summer. It's infusing Lincoln advertising with Gen X-friendly music from the 1980s. And Lincoln dealers are being trained to offer the high-touch service given by some European manufacturers, said Jim Farley, Ford's global marketing chief and former head of Lexus. "There's a tremendous opportunity here in North America to get Lincoln right," he says.
—*Keith Naughton*

The bottom line *Ford dumped its luxe brands to focus on its core vehicles. Now it's left with aging Lincoln just as luxury demand is set to take off.*

Why Lincoln Lags Luxe

Company	Average Age of Owner	Median Income	4-Year College Degree
Cadillac	62	$129,656	21.90%
	49	$169,289	29.07%
LEXUS	56	$141,745	26.45%
Mercedes-Benz	53	$174,558	27.74%
Audi	49	$183,601	31.66%
LINCOLN	62	$113,782	25.47%

DATA: 2010 J.D. POWER AUTO OFFLINE MEDIA REPORT, WINTER

Government Affairs

How GE Helps China Build Business Leaders



▸ CEO Immelt is big on training execs, including those from Beijing

▸ "We make sure our initiatives are aligned"

General Electric is renowned as the training ground of such outspoken champions of American capitalism as former CEO Jack Welch and ex-Home Depot and Chrysler chieftain Robert Nardelli. So it may come as a surprise to some that every summer since 2000, GE has collaborated with the world's largest Communist party to pick about 25 Chinese executives to attend the company's storied leadership program in the U.S.

FROM TOP: JIN LEE/BLOOMBERG; DANIEL ACKER/BLOOMBERG/GETTY IMAGES

The training, at GE's Crotonville (N.Y.) management education campus, helps turn the visitors into allies, GE officials say. Back in China, they can help GE continue to influence decision-makers in the world's fastest-growing major economy. GE's strategy of cementing relationships in the Middle Kingdom has paid off with lucrative contracts to supply jet engines and build wind turbines.

Programs like GE's and other companies' are meant to convince Beijing officials that what's good for those foreign businesses is also good for China. Says GE China Chief Executive Officer Mark Norbom: "We make sure our initiatives are aligned."

The stakes are high. China's economy is poised to pass Japan's this year as the world's second largest after the U.S. **General Motors** sold more cars in China in the first quarter of this year than in the U.S. Foreign companies that don't toe the party line can find themselves with problems, especially now, as China has become more active in promoting local champions and state-owned businesses. GE's program has trained some 200 Chinese executives in conjunction with the Communist Party's Central Organization Department, which names the heads of China's biggest state-run companies. Alumni of the GE program include Ning Gaoning, chairman of **Cofco**, China's largest grain trader.

Using information gleaned from program participants, GE designs its Chinese businesses around the country's goals. Building more efficient wind turbines, for one, is in line with Beijing's push to slow carbon-emissions growth. Through a joint venture with France's **Safran**, GE also is providing jet engines for the new planes China is developing to compete with jets from **Boeing** and **Airbus**. GE's sales in China rose 16 percent last year, to $6 billion; globally, its overall revenue fell 14 percent.

GE pursues more traditional lobbying as well, with about 30 people in its government-relations department in China. According to Senate records, that's almost as many as the 36 people who lobbied the U.S. federal government for GE or its subsidiaries in the first three months of this year.
—Michael Forsythe

The bottom line *China has become a market almost every major global business wants to crack. That puts a premium on strengthening ties with Beijing.*

CLOCKWISE FROM TOP: JUSTIN SULLIVAN/GETTY IMAGES; TIM BOYLE/BLOOMBERG; MARK WILSON/GETTY IMAGES

In brief

Nike and Newsweek



The day the music died: Steve Jobs is shutting down Lala, a music service

Apple
Lala is Killed Off, But May Rise Again
On May 31, Apple will shut down Lala, the online music service it purchased five months ago for $193.3 million, according to a notice posted on its Web site. Apple did not give a reason for the move. Analysts speculate that the company wants to integrate Lala's Internet cloud-based distribution technology into a future version of its iTunes store. Steve Jobs has stepped up the pace of acquisitions, with two deals inked in April, in an apparent attempt to fend off competition from Google, which is also on a buying spree.

InterMune
U.S. Regulators Nix Lung Treatment
The FDA on May 4 rejected InterMune's application for a potential $1 billion-a-year lung treatment called Esbriet. The decision caused InterMune's stock to plunge close to 75 percent by the end of trading the next day. Regulators have asked the Brisbane (Calif.) drugmaker to carry out a new trial of the medicine to prove it delays progression of idiopathic pulmonary fibrosis, a condition that affects some 100,000 Americans.

Washington Post Co.
Turning the Page On Magazines
Washington Post Co. announced on May 5 that it is exploring a sale of *Newsweek* magazine and has hired Allen & Co. as an adviser. The weekly posted losses from 2007 to 2009 and will continue to be



unprofitable this year. Washington Post has been paring jobs at the magazine after cutting its guaranteed circulation to 1.5 million from 2.6 million last year.

Citic Securities
A Sino-Franco Alliance in Finance
Citic Securities, China's largest brokerage by market value, and France's Crédit Agricole are in exclusive talks to combine their global equity brokerage units and investment-banking operations in Asia. As a first step, CLSA Asia-Pacific Markets, which is 65 percent owned by Credit Agricole, would form a joint venture in investment banking and institutional brokerage with Citic. The partnership will yield mutual benefits: CLSA will leapfrog rivals including Goldman Sachs Group in one of the world's fastest-growing economies, while Citic will further its goal of expanding overseas.

BHP Billiton/Rio Tinto
The Taxman Wants A Bigger Cut
The Australian government's plan to boost taxes on mining companies will crimp earnings and perhaps even put a halt to expansion plans for giants such as BHP Billiton and Rio Tinto Group. The government figures that if the levy had been in place over the last decade it would have collected more than $30 billion in additional taxes from miners, whose profits have risen by $74 billion over the period. Other mineral-rich countries such as Chile and Brazil are also considering raising taxes on mining companies.

Nike
Upping the Score In China
In a May 4 meeting with analysts and reporters, Nike Chief Executive Officer Mark Parker said the world's largest maker of athletic shoes will pursue acquisitions and partnerships with the goal of boosting annual revenue 41 percent by 2015. Parker wants to build up Nike's business in fast-growing developing markets. He's looking to double sales in China, which now contributes close to 10% of the company's overall revenues, within the next five years.

Avis Budget Group
Fighting for Control of the Steering Wheel
Dollar Thrifty Automotive is suddenly the belle of the ball. The rental-car company agreed to sell itself to rival Hertz Global Holdings at the end of April for $1.27 billion. Then on May 3, Avis Budget Group cut in, saying it wanted to make a "substantially higher" counteroffer. Avis may attempt a hostile takeover if Dollar's management doesn't allow it to peek into the company's books. Hertz is now under pressure to sweeten its bid for Dollar.



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In New York, Wall Street Is on the Primary Ballot

▶ **A hedge fund lawyer challenges a longtime congresswoman by standing up for the Street**

▶ **"When financial services don't do well, the city and the state don't do well"**

Pummeling Wall Street over its marquee role in the recent financial crisis would seem a can't-miss political strategy this election year. Not for Reshma Saujani, a young former hedge fund lawyer trying to unseat nine-term New York Representative Carolyn Maloney in a Democratic primary contest set for Sept. 14.

Saujani, 34, is taking on a seasoned New York political figure in Maloney, whose district encompasses Manhattan's East Side and parts of Queens. Last year, Maloney co-sponsored a measure, which passed in the House, that would slap a 90 percent tax on bankers' bonuses. (It hasn't yet been taken up in the Senate.) She also championed a new pro-consumer credit-card law that makes interest-rate and fee policies more transparent—and that **Citigroup, JPMorgan Chase,** and other banks opposed.

In contrast, Saujani is against the bonus tax and the special levy that President Barack Obama wants to impose on financial institutions to recover taxpayer money that was used to bail out the U.S. banking system. She calls for a "partnership" with Wall Street to rebuild New York's financial sector. While Saujani says banks should be required to hold more capital and "absolutely" deserve blame for the economic collapse, she cautions against excessive regulation. "When financial services don't do well, the city and the state don't do well," she says.

Saujani is the daughter of Indian refugees who fled from Uganda during the violent reign of Idi Amin. Her political supporters range from Bangladeshi taxi drivers to Wall Street executives who have helped her out-hustle Mahoney for campaign funds this year. **Goldman Sachs** President Gary Cohn gave her $2,400, and **Morgan Stanley** Chairman John J. Mack hosted



Saujani's business-friendly agenda has helped her raise cash. Maloney (below) has the backing of Obama and local Dems



New York House (D)

Reshma Saujani vs. Carolyn Maloney

First elected to Congress in 1992, Carolyn Maloney, 64, has represented New York City's 14th congressional district for nine terms. She is a senior Democrat on the House Financial Services Committee and is chairwoman of the Joint Economic Committee. Maloney (left) won her 2008 election with 80 percent of the vote, facing no primary challenge. In 2008, Maloney voted for the $700 billion bailout of large financial firms and since then has been a persistent critic of Wall Street. She co-sponsored last year's law that required credit-card issuers to provide consumers with more detailed information about changes to their accounts. She also has been an advocate for women's issues and improved medical treatment for people who worked at Ground Zero after September 11.

FROM TOP: PHOTOGRAPH BY SHAUL SCHWARZ FOR BLOOMBERG BUSINESSWEEK; EVAN AGOSTINI/AP PHOTO



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a fund-raiser for her at Manhattan's Links Club.

In late March, Saujani also got $1,000 and backing from Diana Taylor, a **Wolfensohn & Co.** managing director, Citigroup board member, and the companion of New York Mayor Michael Bloomberg (the owner of this magazine, who is staying neutral in the race). "There are thousands and thousands of families that are voters that work at JPMorgan and Morgan Stanley and Goldman Sachs and that live in this district," says Saujani. "Carolyn has forgotten who some of her constituents are." Says Maloney spokesman George Arzt: "It mystifies me in this liberal, Manhattan district that she can run as a champion of Wall Street."

Saujani faces hurdles. Maloney has the backing of the local Democrats and Obama and a strong pro-consumer record. Although Saujani's résumé includes work at three hedge funds, she says voters understand she's not a fat-cat banker. "I've been very honest about where I came from," she says.

The Maloney-Saujani contest is one of many primary skirmishes in 2010. Voters are angry about Obama's health-care overhaul and the weak economy. The Tea Party movement is targeting moderate Republicans, while the liberal MoveOn.org crowd aims to replace centrist Democrats. Below are key primary races worth watching as the year unfolds. *—Robert Schmidt*

The bottom line *In this election, the question is whether Saujani's agenda to protect Wall Street jobs will trump anger about the crisis.*

West Virginia House (D)

Alan Mollohan vs. Mike Oliverio

Mollohan has spent much of his 28-year House career steering federal funds back home. That isn't the résumé-builder it used to be, especially in light of repeated exposés about his close relationship with the recipients. Opponent Oliverio, a state senator, chides Mollohan for those cozy ties and for his muted opposition to cap-and-trade legislation because it could harm the coal-mining industry. **What it Means:** A Mollohan loss in the May 11 Democratic primary could signal a strong anti-incumbency mood.



Kentucky Senate (R)

Trey Grayson vs. Rand Paul

Senate GOP Leader Mitch McConnell, the godfather of Kentucky politics, endorsed Grayson, the secretary of state, to replace retiring Senator Jim Bunning. That might not be enough to repel Paul and his Tea Party supporters, including Sarah Palin. The May 18 GOP primary has become a proxy fight over the party's direction. Paul is the son of Ron Paul, the onetime Presidential candidate and current House member from Texas. **What it Means:** Tea Party activists would send a powerful message to Establishment Republicans if Paul wins.



Arkansas Senate (D)

Blanche Lincoln vs. Bill Halter

Lieutenant Governor Halter is harnessing liberal dissatisfaction with the two-term Lincoln among unions and other Democratic primary voters. Lincoln recently tried to bolster her Main Street credentials by authoring legislation that would prevent big banks from conducting derivatives trading. If she beats Halter in the May 18 primary, her reward will be an equally bruising general-election fight. **What it Means:** The race will test the ability of the angry liberal wing of the Democratic Party to replace moderates with one of their own in a swing state.



Arizona Senate (R)

John McCain vs. J.D. Hayworth

Radio host and former Representative J.D. Hayworth pitches himself as "The Consistent Conservative" in his bid to deny McCain a fifth term, forcing the senator to shun his "maverick" label and take a harder line on immigration. McCain accuses Hayworth of being a pork-barrel spender during his time in Congress. **What it Means:** If McCain loses the Aug. 24 primary, even conservative Republicans who occasionally buck the party could have a hard time.



— by Patrick O'Connor

Midterm Elections

The Young and the Politically Disenchanted

- The high jobless rate is tamping down activism
- "The problem is they have other things to worry about now"

More than 1.6 million college graduates are about to emerge into a cutthroat job market, one where last year's graduates are still scrambling to land entry-level positions.

Class of 2010, meet the competition: the Class of 2009. "It's discouraging right now," says 24-year-old Matt Grant (right), who graduated 10 months ago from Ohio State University with a degree in civil engineering and three internships. He finally has a job—as a banquet waiter at a Clarion Inn near Akron. Grant has applied for more than 100 engineering positions around the country. "It's getting closer to the Class of 2010 [graduating]," Grant says. "I'm starting to worry more."

So is the Obama Administration. The plight of the young and cubicle-less could hurt the Democrats in midterm elections. The youthful voters who helped propel the party to victory in 2006 and 2008 show signs of waning enthusiasm amid their economic travails. "It's definitely tamped down the energy and the excitement and activism that the Obama campaign had sparked among that entry-level age group," says Democratic strategist Joe Trippi, who advised Howard Dean's 2004 Presidential campaign and is involved in several midterm races. "The problem is they have other things to worry about now."

The party's lead among younger voters already has dropped sharply. While in 2008 Democrats held a 62-percent-to-30-percent advantage over Republicans among "millennials" born after 1980, that 32-point margin shrank by the end of March to 18. Then, 55 percent leaned Democratic, vs. 37 percent Republican, according to polls conducted by the Pew Research Center for the People & the Press from October 2009 to March 2010.

The young are also growing alien-

MOLLOHAN: CONGRESSIONAL QUARTERLY/GETTY IMAGES; GRAYSON: THE NEW YORK TIMES/REDUX; PAUL: ROLL CALL/NEWSCOM; LINCOLN: AP PHOTO; HALTER: THE NEW YORK TIMES/REDUX; MCCAIN: GETTY IMAGES; HAYWORTH: AP PHOTO. OPPOSITE: PHOTOGRAPH BY LAUREN FLEISHMAN FOR BLOOMBERG BUSINESSWEEK



ated by politics in general—and Obama in particular. Interest in voting has dropped faster among the under-30 set than any other age group. In March, only 44 percent of registered voters under 30 said they were "absolutely certain" to vote this year, vs. 78 percent in June 2008, according to Pew polls. Some of the disillusionment extends to the President. "I was inspired by how he was talking about creating new jobs," says Grant, who voted for Obama in 2008 but is unsure how he will vote this fall. "I guess it takes a lot to get things changed."

Despite a slight uptick in hiring this spring, the May 7 jobs report could show an increase in unemployment among twentysomethings as the strengthening economy entices job seekers who had given up back into the labor market.

Unemployment has been stuck at 9.7 percent since January, and for those under 25 it's a considerably higher 18.8 percent. Fewer than 60 percent of 20- to 24-year-olds had jobs in the first quarter, the lowest level since 1964.

The Administration has concluded that the best response is to focus on efforts to revive overall employment and bolster assistance for higher education, since it may be better for some to gain more skills and delay entry into the job market. "What's clear is that there is harm to those who graduate at the wrong time through no fault of their own, which is one reason why it is so important to improve the jobs market," says White House Budget Director Peter Orszag.

The consequences could last far longer than the recession itself. Research by Lisa B. Kahn, a professor of economics at Yale University, found that those who graduated during the peak of the early 1980s recession suffered wage losses compared with those who came into the job market during the decade's boom years. Even 18 years later, the wages of recession graduates continued to lag. An unlucky graduation year cost the average college student more than $100,000 in lost wages over the span of the study.

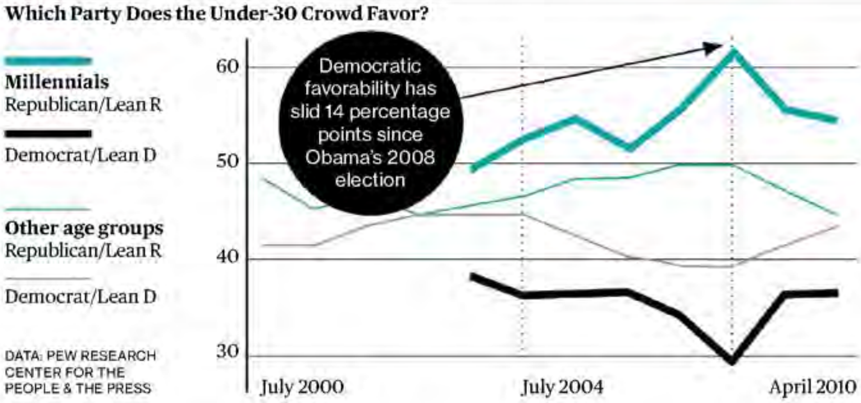
Democratic officials understand the stakes. Democratic National Committee Chairman Tim Kaine just announced plans to put $50 million into a voter turnout effort that will place a heavy emphasis on "new voters," many of whom are under 30.

John Podesta, president of the liberal Center for American Progress and an informal adviser to Obama, has been pressing the White House to absorb sidetracked graduates by accelerating plans to expand volunteer service programs like AmeriCorps and VISTA.

—*By Mike Dorning*

The bottom line *Unlike hopeful college graduates who aided Obama's 2008 campaign, grads are busy job hunting and are abandoning Democratic politics.*

Which Party Does the Under-30 Crowd Favor?



Green Jobs

Cash for Caulkers? A Deal That's Not Sealed

- The Senate has yet to approve rebates for insulation upgrades
- Homeowners are ready. "The missing cog is the financing"

Dan Thomsen spent the decade before the real estate market collapse refurbishing and flipping houses in Los Angeles. Then, with no remodeling work, the 45-year-old contractor switched gears and got certified to do home energy audits and insulation upgrades. He had hoped to take advantage of the proposed "cash for caulkers" plan—federal incentives for homeowners to make their houses more energy-efficient.

Thousands of other contractors around the country had the same idea early last year when the White House and Congress started talking about payments for weatherizing homes.

Since then, they've been waiting on Congress to pass a rebate plan. The House was expected to vote on the legislation on May 6; it's unlikely the Senate will get around to it before mid-June. Last year, Thomsen charged more than $30,000 for training and new equipment on his credit card and hired two workers. "The missing cog is the financing," he says.

The House bill makes $6 billion in rebates available to pay for as much as half the cost of new windows, insulation, furnaces, and other improvements that save energy—up to $8,000 per house. The measure requires homeowners to hire contractors who have been certified to do such jobs. Industry groups estimate that some 12,800 contractors are now certified, more than double the number in 2008.

The legislation has bipartisan support and backing from environmental groups and the construction industry. Contractors, though, remain in limbo as homeowners hold off until they're certain they'll get rebates. Thomsen has done 35 energy audits in the past six months and has gotten only three insulation jobs—work that brings in $8,000 to $12,000, vs. $1,000 or less for audits. "When I jumped in, everybody said [the incentives] were going to take effect in six months," Thomsen says. "Now it's going to be a year and six months."
—*John Tozzi*

The bottom line *Contractors hoping that home retrofits might lift them from the ruins of the housing bust are waiting on Congress to act.*

5,113

The number of active and inactive nuclear warheads in the U.S. arsenal, down from 22,217 in 1989. The Pentagon disclosed this for the first time on May 3.

DATA: DEFENSE DEPT.



The First Lady tours the Fresh Grocer supermarket in Philadelphia as part of her anti-obesity campaign

Nutrition Politics

After the PR Party With Michelle Obama

- Foodmakers that joined her anti-obesity campaign may balk
- "This is not altruism; they are in the crosshairs"

Only two months ago it seemed there might be a united front in the war on fat. In March, First Lady Michelle Obama challenged food and beverage companies to "entirely rethink" products high in salt, sugar, and fat as part of her campaign against childhood obesity. The companies eagerly jumped on her bandwagon. **Kraft Foods** vowed to make deeper cuts in salt content. **Coca-Cola** and other drink purveyors trumpeted their decision to put calorie information on the front of containers. **PepsiCo** said it would stop selling full-sugar drinks in schools globally by 2012.

Now the Food & Drug Administration is making it clear that the displays of goodwill won't be enough and that the agency will consider stiffer regulations to get what it wants. The beverage and food companies, eager to bask in the publicity surrounding Obama's initiative, see that they are being asked to commit to labeling and other changes that may prove far costlier than they anticipated. "This is not altruism; they are in the crosshairs, and they're going to stay in the crosshairs," says David A. Kessler, who led the FDA in the 1990s and is the author of *The End of Overeating*.

A late April meeting between Administration officials and food manufacturers turned rancorous over proposed next steps, according to an attendee. A big sticking point at the meeting was the FDA's consideration of "red-light, green-light" labeling on package fronts, or possibly a five-star ranking system, to help consumers quickly determine whether a product is healthy or not. The agency wants companies to voluntarily agree to front-of-package standards by the fall and has "not ruled out regulatory approaches" to force compliance, says Michael R. Taylor, the FDA's commissioner for foods. Says Scott Faber, the Grocery Manufacturers Assn.'s vice-president for federal affairs: "The FDA and the food industry are in alignment on the goals for a front-of-pack food labeling initiative, and we are working together to conduct and learn from consumer research."

When the First Lady, at a Mar. 16 meeting in Washington, first urged the Grocery Manufacturers Assn. "to move faster and to go farther" to help end childhood obesity within a generation, Kraft said it would extend a previous move to reduce salt in its tortillas and wraps to bacon and other products. **General Mills**, the maker of Lucky Charms cereal and Progresso soup, in

SAUL LOEB/AFP/GETTY IMAGES; OPPOSITE: KRISTOFFER TRIPPLAAR/SIPA PRESS

Social media: Foursquare's advantage Page 34 ►



April pledged to cut sodium by 20 percent in several products by 2015. The American Beverage Assn. is now running television and print ads touting the drink industry's commitment to lower by 88 percent beverage calories in schools.

Yet critics say the initial gestures were just that–and neither as generous nor as voluntary as they seemed. The beverage group's ads, food-marketing expert Phil Lempert says, may leave the mistaken impression that the companies acted on their own to remove full-calorie soda from schools. "It's not the soda companies that have done it, it's the school systems," says Lempert, an author and frequent commentator on food-industry trends. The new health-care law requires companies to list calories on package fronts, says Margo G. Wootan, nutrition policy director for the left-leaning Center for Science in the Public Interest.

When it comes to the industry's reliance on marketing top sellers such as Mountain Dew and Lay's potato chips to children, their "hands are tied," says Marion Nestle, a professor of nutrition at New York University. "They make products that they sell to kids, and if they're not going to sell them to kids then they're not going to make money," she says.

Consumer activists say "follow the money" to see the food industry's true intent, pointing to the $17 billion acquisition by the Northfield (Ill.) company in March of British candy maker **Cadbury.** In the last five years, as Kraft talked about its emphasis on healthier foods, the company also spent nearly $28 billion on acquisitions–all of it to buy cookie and candy companies. Says Susan Davison, a spokeswoman for Kraft: "We've long been a leader in this area and continue to take our consumers' interests on health and wellness topics quite seriously."

A real campaign to end childhood obesity will entail nothing less than "a complete social transformation as to how the American family eats," Ezekiel J. Emanuel, a special adviser on health policy to the White House, said at a Bloomberg-sponsored forum in Chicago on Apr. 27. That may be more than the industry can swallow. —*Kate Andersen Brower and Matthew Boyle*

The bottom line *The food and beverage industries may balk if the First Lady asks them to take stronger action as part of her anti-obesity campaign.*

Out of Hibernation



James Cayne, the former CEO of Bear Stearns, told the Financial Crisis Inquiry Commission on May 5 that market forces and investors betting against his firm caused its collapse in 2008. "The market's loss of confidence, even though it was unjustified and irrational, became a self-fulfilling prophecy," Cayne, 76, said in his first public appearance since the mortgage market collapse destroyed his company.

Law Enforcement

Forget the DNA Sample, Get Me the Vehicle ID

► A 1950s throwback helped crack a 21st century terrorism case

► "Now this is déjà vu," says New York Police Commissioner Kelly

In this age of high-tech forensic science glorified by the spin-off-crazy *CSI* television franchise, the FBI ultimately arrested a suspect in an attempted car bombing in New York's Times Square with a decidedly low-tech automotive identification system that dates to the 1950s.

The auto industry created a system of vehicle identification numbers (VINs) in 1954 to identify individual motor vehicles. The U.S. started requiring standardized 17-character VINs in 1981. Since then investigators have found them incredibly useful in tracking down bad actors.

Faisal Shahzad, a naturalized U.S. citizen from Pakistan and the suspect accused of using a 1993 Nissan Pathfinder containing a bomb to attack New Yorkers on May 1, may have thought he was covering his tracks by removing the vehicle identification number on the dashboard.

He was wrong. **Nissan Motor** had voluntarily stamped the VIN on the firewall separating the engine from the cabin–and had included a different serial number system (used to track inventory and identify stolen parts) on the engine, chassis, and transmission, says spokesman Scott Vazin. Investigators say they found the VIN on the Pathfinder's engine. Nissan says they must have found the serial number and then matched it to the VIN.

New York Police Commissioner Raymond W. Kelly told reporters that finding the VIN number "identified the owner of record, who in turn, as we know, sold it to the suspect." During the 1993 World Trade Center bombing case, detectives traced the VIN number of a Ryder truck that was used to carry the explosives. A suspect was arrested after returning the truck to claim a deposit. Says Kelly: "Now this is déjà vu," —*Justin Blum and Henry Goldman*

The bottom line *The vehicle number required by law on every dashboard is just one way of identifying a vehicle.*

James Warren

The Hole in High School Equivalency



The GED was created as a second chance for students to get a degree and move up the economic ladder. New data show it fails to deliver

Here's one misconception about the GED: It stands for General Education Development program, not, as is commonly thought, General Equivalency Degree. Here's another: The program doesn't do what it's supposed to do.

The GED was introduced in 1942 to give returning World War II veterans who hadn't finished high school a chance to show they were on a cognitive par with regular graduates. In the late 1940s states began allowing civilians to take the GED, too, and by 1957 there were more civilians with certificates than vets. Fueled by government policies that encouraged it as a second chance for dropouts and by its widespread use in prisons, the numbers of GED holders soared from 50,000 per year in 1960 to more than a million in 2001. According to the Bureau of Labor Statistics and GED Testing Service, 12 percent of all high school credentials are now GEDs.

Despite raising standards and making the GED tougher to pass in 2002, 700,000 Americans still take the eight-hour multiple-choice test each year. And although the 500,000 annual GED recipients are counted as high school graduates for key national education statistics, new work by the Nobel Prize-winning economist James J. Heckman, revealed here for the first time, shows that its value is negative.

Looking at a random sample of 1,000 GED holders five years removed from gaining their certificates, Heckman found that recipients have easier entrée into colleges than dropouts, but they often blow the opportunity. Only 31 percent actually enroll, with the large majority of certificate holders going to two-year colleges. Seventy-seven percent last no longer than one semester. They ultimately earn an average of $30,855–roughly the same as high school dropouts when you account for noneducational differences like household background that make the statistical comparison like-for-like.

Heckman is an empiricist. He also has a cause: He believes society invests in education too late for it to make much difference. "To solve later skill deficits, we need to invest in closing early skill deficits," says Heckman. "Waiting to address these issues makes the remedy much more costly–or impossible." Countless studies show that increased spending on early childhood education would affect both cognition and character at its most malleable, lowering dropout and juvenile delinquency rates by building "soft skills" such as discipline, self-esteem, motivation, collegiality and persistence.

Heckman's work shows that GED recipients do about as well as regular high school grads on academic tests. To that extent, the program works. But his analysis also demonstrates that those "soft skills" are what American education misses amid the growing obsession to reward cognitive learning. GED recipients who fail do so not because of their inability to do math but because of noncognitive abilities.

Certainly there are GED recipients who meld academic achievement with high personal motivation. The majority tend to lead distinctly unstable lives, with patterns of drug use and divorce. Governments may deem their certificate "equivalent" to a traditional high school degree, but the labor market does not. They earn no more than high school dropouts.

Still, on both a state and federal level, the GED is encouraged. The federal Adult Education and Job Corps programs use it extensively, with Adult Education responsible for about half the GED certificates. In addition, $400 million is made available for prison education programs including the GED. One federal report says 26 percent of inmates get GEDs.

Its popularization accelerates the high school dropout rate, Heckman shows, by offering the less motivated a simpler alternative to high school. Factor out GEDs, and the U.S. high school graduation rate would decline by 7.4 percent. For black males, the drop is 10.3 percent–bringing them to the same level they were at in 1960. But we don't factor them out and instead allow failing education systems to mask the poor job they've done closing the achievement gap. President George W. Bush was correct in citing a "soft bigotry of low expectations" as he pushed the original No Child Left Behind Act of 2001.

The public demands accountability, and politicians rush toward what's easiest to measure. Education Secretary Arne Duncan recently told Congress that it "is absolutely the goal" to reauthorize No Child Left Behind, the key law on federal policy toward public schools, replete with the requirement to have all students proficient in math and reading by 2014. If he believes, as his boss clearly does, that this is an era of evidence-based decision making, he and state policymakers should heed Heckman–and avoid the false sense of progress the GED bestows. Ⓑ

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Technology

Social Media's New Mantra: Location, Location, Location



CEO Crowley's year-old social network has signed up Pepsi, Bravo, and other partners

PHOTOGRAPH BY NATHAN PERKEL FOR BLOOMBERG BUSINESSWEEK

▶ Fast-growing network Foursquare is luring potential buyers

▶ "A matter of time" before big rivals copy its "check-in" service

Here's Dennis Crowley's ideal way to end the day: At 6 p.m., his iPhone alerts him to the evening's plans. It has already checked his friends' calendars and knows who's free tonight, so it suggests a restaurant they've all wanted to try. It notes when a table is available and informs him that three other friends are planning to hang out across the street so they can meet up later. And it all will happen—soon, he says—through **Foursquare**, the location-based mobile application and Web site Crowley co-founded with Naveen Selvadurai last year. "Every day, we tick off another couple of things that get us closer to being able to do that," says Crowley, 33.

Harnessing GPS-enabled mobile technology to let users broadcast their location is not a new idea. A service called Loopt has been offering friend-locating apps, and **Google**'s Latitude feature on its maps can. Foursquare, a 20-person company that operates out of a crowded loft in New York's East Village, adds a game-like twist. Its 1 million-plus users earn badges by "checking in" at certain bars, restaurants, and other venues by pressing a button on the app upon arrival. A user can earn a "mayor" icon from a bar if he or she has checked in more than anyone else during the previous 60 days. The business model is simple: Generate as big a user base as possible and sell national brands and local merchants on the possibilities of marketing to people as they congregate—ready to eat, shop, or spend.

The service has certainly gotten buzz. On Apr. 16 (that's four times four—four squared), fans held "Foursquare" parties in more than 150 cities worldwide. The British soccer team Manchester City asked supporters to check-in en masse during the May 5 match at home against Tottenham Hotspur. More than 3,000 restaurants, bars, and other venues use Foursquare to attract customers with promotions.

Crowley says Foursquare is drawing interest from potential buyers in Silicon Valley, though he won't say who he's been talking to. Placing valuations on startups like Foursquare is famously difficult; their revenues are nascent, and the lasting impact of their technology is difficult to gauge. Tristan Walker, a Stanford MBA student moonlighting as Foursquare's head of business development, says the company brings in money from paid partnerships. **PepsiCo**, **Zagat**, and more than a dozen other brands have signed deals with Foursquare. Walker won't disclose terms or comment on whether Foursquare is profitable.

The key question is whether


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Visit StayingIsBelieving.com

Foursquare's check-in twist is enough to build a sustainable business. **Gowalla** and **Brightkite** have built rival networks complete with their own check-in features, while established names like **Twitter** and **Yelp** also boast location-based tools.

At least some partners think Foursquare is unique among competitors. The cable television network Bravo launched its partnership with Foursquare in February. The more than 10,000 viewers who have been participating in **Bravo**'s Foursquare promotion can "unlock" badges by checking in at locations linked to Bravo shows. (The venues range from restaurants favored by some of the celebrities on *Top Chef* to retailers popular with the women on *Real Housewives*.) Participants also get tips on what to do or buy at the locations and, in some cases, earn prizes for getting there first. "It's such a unique way to talk to our audience at a local level," says Ellen Stone, Bravo's senior vice-president for marketing.

Given the growing number of players now jumping into geolocation services, Crowley has heard the arguments that he should get out while he's ahead. "I view Foursquare as more of a feature that gets integrated into a larger service," says Michael Gartenberg, a partner with the research firm Altimeter Group in New York. "It's just a matter of time before the Facebooks and Twitters of the world start to offer check-in as a service." Gartenberg adds that he has stopped using Foursquare. "It was like a demanding girlfriend who wasn't giving me a whole lot in return," he says. "All I got to be was the mayor of the bagel shop."

Bonin Bough, PepsiCo's global director of digital and social media, says his company has been experimenting with Foursquare. Pepsi teamed up with the social network last December for a charity drive in New York. Every time someone checked in within the city limits, Pepsi donated 4¢ to a nonprofit called CampInteractive—to a maximum of $10,000. Bough says he was impressed with the user response on that campaign, and is intrigued with the way Foursquare's game aspect motivates people to go to events. Still, he's trying out other location-based services, including the company's own "Pepsi Loot" initiative that gives customers points for buying drinks in more than 200,000 restaurants. "It's a huge opportunity," he says. "But I don't think we'll know the winners for a while."

Crowley says he's too busy building his company to dwell on an exit strategy. "All this talk about valuations and exits is a distraction. We're doing interesting things. Users seem to love it." He's been down the startup road before: As a graduate student at New York University, Crowley developed a location-based text-messaging service called Dodgeball with Alex Rainert (now a Foursquare employee) that he sold to Google in 2005 for undisclosed terms. "We were there for two years, trying to make it bigger and get people excited about it," says Crowley. "We were like, 'Man, if they turn it off, we have to build another one.'" —*Diane Brady*

The bottom line *Foursquare's location-based marketing is a "huge opportunity" that is sure to attract more competition.*

Quoted

"There will be companies that excel. And occasionally they will excel because of luck. But usually they excel because of brains."
—Warren Buffett, speaking about Apple's Steve Jobs on Fox Business Network



36



India has become a top export market for Chinese tech companies, but rising tensions could hurt trade

Trade

A Setback for China's Tech Ambitions in India

- Huawei and ZTE are banned. Are other Chinese companies next?
- "The Indians are incredibly paranoid about China"

Facing increased competition at home and government pressure to expand overseas, Chinese telecom equipment makers have been looking toward India. The country is already the biggest export market for China's two leading phone gear manufacturers, Huawei Technologies and ZTE, and both companies have made India a top priority. "If [Indian] government policies are favorable," ZTE India managing director D.K. Ghosh said on Apr. 14, "we will further scale up our investments."

When it comes to China's Big Two, though, India's policies are hardly favorable. The government has sent letters to Indian phone companies saying they can't buy equipment from Huawei, ZTE, and several other mainland companies due to security risks. In April, researchers reported that Chinese hackers had targeted Indian defense computers. And in December, India banned many Chinese cell phones, also because of security concerns, and imposed anti-dumping duties on transmission gear from Huawei and other vendors. Huawei says it's committed to "the development of the Indian telecoms industry." ZTE says it adheres to Indian law.

The new restrictions don't apply only to the Chinese. An Israeli company and

Derivatives reform: Fear on the Street page 42 ▶



California-based U.T. Starcom (which does most of its manufacturing in China) were hit, too. Yet few analysts doubt that China is the main target of the restrictions. "The Indians are incredibly paranoid about China," says David Zweig, a professor of politics at Hong Kong University of Science & Technology.

The tensions could be a problem for other Chinese tech companies. As India has grown to the world's No.2 cellular market in recent years, its imports of Chinese handsets have soared. Tencent, China's top instant-messaging service, has invested in Indian Internet startups. And India is the third-largest operation (after China and the U.S.) for Alibaba.com, an online marketplace based in Hangzhou. An Alibaba spokeswoman says the company isn't worried about the restrictions. Tencent declined to comment.

While India's phone companies could buy equipment from Western suppliers, they would pay far more. So carriers are lobbying the government for a change—and hedging their bets, says Sanjeev Aga, managing director at Mumbai-based Idea Cellular. "A lot of companies are finding suppliers in India," Aga says. Any resolution, though, may ultimately require talks between the two governments, says Kunal Bajaj, a partner with market research firm Analysys Mason. "There is going to be quite a bit of posturing between the two countries for some time," he says. *–Bruce Einhorn, with Ketaki Ghokale and Mehul Srivastava*

The bottom line *Chinese tech companies had been counting on India for growth, but security concerns have spurred New Delhi to limit imports from China*

Silicon Valley

Why Startups Hate Private Stock Sales

▸ **Valuations of companies could be skewed**

▸ **"I worry about someone buying my stock"**

One of the perks of working for Silicon Valley startups is the restricted stock ladled out to employees. If the companies go public, the riches can come pouring in. So what happens when the IPO market freezes up, as it has over the ➡

Telecom

CenturyTel's Growing Landline Empire

CEO Glen Post has built CenturyTel into the No. 3 U.S. landline outfit after AT&T and Verizon. His purchase of Qwest assets gives him 12 percent of the market. CenturyTel stock fell 3.3 percent on Apr. 22, the day the deal was announced. Some Qwest investors have sued, saying the $10 billion price is too low. *—Amy Thomson*

■ States with CenturyTel operations

1994



Completes acquisition of Celutel

1997



Pacific Telecom acquisition

2002



Acquisition of phone lines from Verizon

2007



Madison River Communications acquisition

2009



Embarq acquisition

2010



Combined Qwest and CenturyTel territories*

*REGULATORS MAY REQUIRE THE COMPANIES TO DIVEST SOME MARKETS BEFORE THE DEAL CLOSES.
DATA: COMPANIES

OPPOSITE PAGE FROM TOP: SUSAN MEISELAS/MAGNUM PHOTOS; NATI HARNIK/AP PHOTO

past two years? Increasingly, employees have turned to private, secondary markets to squeeze cash from those shares. And that has some high-profile startups miffed.

The complexities of secondary markets became clear last month when **Facebook** clamped down on the sale of its shares. Now networking site **LinkedIn** is considering similar limitations, according to severak people familiar with the company; so is game developer **Zynga**, says Chief Executive Officer Mark Pincus.

Pincus says he fears that an employee, trying to get the best price for his shares, may divulge company secrets: "I worry about someone buying my stock and I worry what they're told at the point that they're buying my stock."

The recent rebound in U.S. IPOs has heightened concern because sales of shares on secondary markets can affect the valuation of a company. There were 9 IPOs of venture-capital-backed companies in the first quarter of this year, compared with 12 in all of 2009 and 8 the previous year, according to the National Venture Capital Assn.

Facebook says an IPO is not in the works, but anticipation is building. On **SecondMarket,** a private exchange based in New York, shares of Facebook are selling at $50. In November, buyers paid roughly $21. "It would make a lot of sense if a company is getting close to a public offering to not be having these kinds of transactions," according to Dixon Doll of venture capital firm **DCM**. "It would make it hard for an underwriter to determine a fair valuation if people are buying and selling shares in private transactions."

Facebook spokeswoman Annie Ta says the company wanted "to better comply with insider-trading laws and to protect the interests of the company and its employees and shareholders." LinkedIn declined to comment.

SecondMarket handled $130 million in nonpublic equity transactions in the first quarter—more than all of last year. Managing Director Adam Oliveri says he is mindful of concerns that such trading could encourage leaks of privileged information. "Our business model is organized to address those concerns," he says.
—Brian Womack, Joseph Galante, and Douglas MacMillan

The bottom line *Silicon Valley startups want to shut the lid on backroom share sales in advance of possible IPOs.*

Innovation

MIT's Mind-Bending Media Lab

The Massachusetts Institute of Technology's Media Lab, founded in 1985, has given birth to such inventions as the video game Guitar Hero and e-Ink, the screen display used in the Amazon Kindle. In March, the prolific design and engineering center opened a new $90 million wing designed by Japanese architect Fumihiko Maki.

The 163,000-square-foot addition emphasizes transparency. Its exterior walls are glass, as are many on the inside. Eight laboratories are spread over six floors, and some space is shared with the university's architecture and planning school. Each lab houses several teams attacking a central theme from different angles. In one, engineers, computer scientists, and other researchers work on cutting-edge education technologies. Another group has the assignment of imagining an ideal city and then designing a car suitable for motoring around it. "Serendipity occurs when you discover an invention or a person who has an idea or a thought that you might be interested in that day," says director Frank Moss. "The building makes that happen." B *—Arik Hesseldahl*



Street view. Fumihiko Maki's expansion is connected to the Lab's original building, designed by I.M. Pei.



Upper atrium. All of the facility's labs have glass walls; in some spots three labs are visible at once.

MIT's Media Lab expansion hosts a range of new research projects:

East Lab (2nd and 3rd floors)

Home of "biomechatronics:" the study of prosthetics and exoskeletons. A team run by an engineer who lost both legs in a climbing accident has developed the Powered Ankle-Foot. It uses battery-driven motors to help lower-limb amputees walk. Sensors on the bottom detect terrain and aid in balance.



Nicholas G. Hayek Swatch Lab (3rd and 4th floors)

Here's where a group is working on the CityCar, a vehicle designed for the "smart city" of the future. CityCars will fold up for compact storage at electrical charging stations. They're powered by motors in each wheel, which allows them to move sideways for easy parking and pivot 360 degrees. Two companion projects are focusing on super-efficient electric scooters and bicycles.





The main lobby atrium rises four floors above street level and is flanked by exhibition spaces on either end. The space is bisected by elevator shafts with transparent cars .



Some labs are double-height rooms. Offices line the walkways above the main workspaces.



The cafeteria and lounge on the 5th floor. Upstairs is a lecture hall and conference space.



LEGO Learning Lab (4th and 5th floors)

Before this lab moved to the new wing, it produced Lego's Mindstorm toy robots. Today, one project is Sixth Sense, a wearable computer in which keyboard and mouse are supplanted by the user's fingers. Hand movements become commands. A tiny projector turns any surface into a display: Your bare wrist can become a virtual watch, an ordinary newspaper can feature live video (above).

Telmex Lab for Communications and Development (4th and 5th floors)

Here, the "camera culture" team is using inexpensive imaging devices to update the scan code. The Bokode looks like a dot, 3 millimeters across. It can contain well over 10 megabytes of information. That might be reams of product data and instructions or a song download. Software will allow consumers to access this information using a smartphone camera.



BT Lab for a Connected World (3rd and 4th floors)

One theme here is "tangible media." An example is a 3D modeling system called SandScape. It's a box full of sand-like beads that are really a computer interface. If you form them into a mound or sand castle, those precise shapes appear on a display.

Motorola Innovation Lab (5th floor)

The Living Wall project uses "smart" wallpaper to turn an ordinary surface into a household control panel for lighting, heating, appliances, and sound systems.



PHOTOGRAPHS CLOCKWISE FROM TOP LEFT: ANDY RYAN (4); MIT MEDIA LAB (4); WILLIAM LARK JR/SMART CITIES/MIT MEDIA LAB; MIT MEDIA LAB; ANDY RYAN/MIT/BLOOMBERG

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Get Ready for the World's Biggest IPO



AgBank serves more than 350 million customers, a number greater than the population of the U.S.

▶ China's AgBank aims to raise as much as $30 billion

▶ Mainland banks "are no longer cashiers for the government"

The World Expo that kicked off in Shanghai on May 1 is the kind of spectacle Beijing officialdom loves, a grand showcase for China's economic ascendancy. Another fanfare event, this time in the realm of global finance, is the initial public offering expected this summer by the **Agricultural Bank of China,** which may prove to be the world's biggest ever. The state-owned lender hopes to raise $20 billion to $30 billion, a top Chinese official told the *Beijing Times* last month. A successful offering by AgBank would be another step in the evolution of Chinese lenders from government-controlled playthings to globally competitive banks.

Everything about this deal is big, even the $200 million in bank underwriting fees up for grabs for global investment banks. AgBank has hired 10 banks, including **Deutsche Bank** and **Goldman Sachs,** to manage the dual offering in Shanghai and Hong Kong expected by July. AgBank, like other big mainland banks, is in the midst of a makeover. Beijing has spent about a decade (and $650 billion) pushing banks to clean up their balance sheets, upgrade lending practices, and invest in better technology. China's banks "are no longer cashiers for the government," says David Wu, a partner in Beijing with **PricewaterhouseCoopers.** "They are commercial banks."

That's a stretch, since AgBank is only selling up to an 18 percent stake, say two sources with knowledge of the matter, and will remain majority-owned by the government after it lists. Beijing also kept a controlling interest in other big banks, such as the **Industrial & Commercial Bank of China** (ICBC) and **China Construction Bank,** that went public last decade. While U.S. and European banks were laid low by the recent credit crisis, Chinese banks, powered by a robust economy, have grown stronger. ICBC's market capitalization is $227 billion, the biggest of the world's banks, and China Construction Bank is right behind at $190 billion. Bank of America, by contrast, is valued at $176 billion.

The AgBank pitch will come at a moment of market skittishness, and the quality of its loans is suspect

AgBank does boast some impressive strengths, including a customer base of more than 350 million people, a figure that exceeds the population of the U.S. In a year when other banks around the world lost piles of money, AgBank's earnings expanded by 26.3 percent in 2009, to $9.52 billion, according to a Mar. 11 report in the state-owned *China Daily*. AgBank Chairman Xiang Junbo is a Peking University-trained lawyer and former deputy governor of the **People's Bank of China,** the nation's central bank. Both he and AgBank President Zhang Yun, who holds a PhD in economics from Wuhan University, are respected players in Chinese finance.

Still, pitching AgBank to investors may be a challenge. The bank lacks the big-name Chinese corporate clients, with the notable exception of agricultural sector players, that other mainland banks enjoy. The majority of its depositors are in far-from-wealthy, though fast-growing, middle-of-nowhere cities, plus the quality of AgBank's loan book remains suspect; the government transferred dud loans off AgBank's books, lowering its nonperforming ratio from 20 percent in 2007 to 2.9 percent now. Yet on Apr. 30, China's National Audit Office revealed the bank violated rules on $1.6 billion in loans it made in 2008, with some of the money ending up in the stock market and unqualified projects.

IMAGINECHINA/ZUMA PRESS

AgBank's balance sheet problems are "massive," says Liu Ming, portfolio manager at Shenzhen-based investment firm Dacheng Fund Management.

The AgBank offering will also come at a time of market skittishness. Stock markets in Hong Kong and Shanghai are off 7 percent and 12.8 percent, respectively, in 2010. Investors are worried that property bubbles, generous lending, and rapid monetary growth will derail China's white-hot economy. Nor is AgBank the only lender trying to get its hands on big sums of cash this year. Listed banks, including ICBC, Bank of China, and China Construction, hope to raise a combined $26 billion though share and bond sales.

26.3%

AgBank's earnings growth in 2009. Its profit for the year hit $9.52 billion, according to *China Daily*

Credit conditions are also tightening: On May 2, China's central bank announced that the country's biggest lenders would have to increase their capital reserves by 50 basis points to 17 percent, the third such hike this year. "There are headwinds for the sector," says Wendy Liu, head of China research at Royal Bank of Scotland in Hong Kong. Chinese banks "lent too much last year" and so need to replenish their capital now.

In spite of such concerns, market pros like Patrick Ho, an analyst with UBS in Hong Kong, say there will be plenty of big financial institutions willing to take a chance on AgBank, given China's robust overall economy. Right now, listed Chinese banks are trading at modest price-to-earnings ratios of around 10. If AgBank prices its shares in line with that level, "there should be institutional demand" and "enough liquidity in the market to lap up those shares," says Ho.

The longer-term challenge for AgBank is learning how to operate in a less regulated environment. With the government controlling banks' lending and deposit rates, and keeping the yuan fixed against the dollar, the banks "have lived in a controlled environment," says John Wadle, head of Asian banks research at Mirae Asset Securities in Hong Kong. Liu Mingkang, chairman of the China Banking Regulatory Commission, on Apr. 16 warned Chinese lenders that this situation would not last forever and called on them to restructure. "Banks are going to have to adjust to lower margins," says Wadle.

After AgBank, analysts expect more banks to list their shares. China has more than 130 smaller banks owned by city governments that it hopes to dress up for the big dance in the global capital markets. "This whole cycle of bringing the banks to the international stage is only maybe a third over," says James Antos, an analyst in Hong Kong with Mizuho Securities. "We are only at the beginning."
—Bruce Einhorn with Luo Jun

The bottom line *If successful, AgBank's mega-stock offering may mean more IPOs of smaller banks controlled by local governments in China.*



Regulation

Why Wall Street Fears Derivatives Reform

- **A proposed law could force banks to exit a highly profitable business**
- **"This bill ... caught everybody by surprise," says an analyst**

A two-page provision tucked inside the 1,500-plus-page financial reform bill being debated in the Senate has Wall Street worried. The provision would change the structure of about 40 of the largest U.S. banks by forcing them to spin off their derivatives businesses, which provide billions of dollars in profits annually.

While derivatives such as credit default

swaps have become infamous for their role in the banking crisis, currency and interest-rate swaps represent a much bigger share of the business. U.S. commercial banks generated a record $22.6 billion in derivatives trading revenues in 2009, with $14.5 billion of that coming from interest-rate contracts, according to a survey of 1,030 federally insured banks by the Office of the Comptroller of the Currency.

Senator Blanche Lincoln (D–Ark.) added the provision to the reform bill, which already included restrictions on derivatives. "This bill has moved so far left, so hard, that it's caught everybody by surprise," says Paul Miller, a bank analyst for FBR Capital Markets. Some analysts suggest that banks might be able to hang on to derivatives units by turning them into separately capitalized subsidiaries. But Lincoln, speaking on the Senate floor on May 5, emphasized that banks should not be in the derivatives business. "In my view," she said, "banks were never intended to perform these activities."

Other elements of the bill would require that standard derivatives contracts be traded on exchanges, and that derivatives traders use clearinghouses, which guarantee contracts between two companies, for most transactions. The effect of those two measures would be to increase disclosure, raise capital requirements, and lower profit margins for what has been an extremely lucrative industry.

Lincoln's initiative has been denounced by FDIC Chairman Sheila Bair, Federal Reserve staff and, indirectly, by Treasury Secretary Timothy Geithner, who said last week that "you would not make the system more stable by taking functions that are integral and central to banking and separating and putting them somewhere else."

At this point it's not clear whether the Lincoln provision will survive. The floor debate on the financial overhaul bill opened with other contentious issues last week. While senators debated "too-big-to-fail" and the fate of a consumer protection agency, members of both parties discussed how to soften or kill the "spin-off" provision. Most observers expect the language to be pared down. But with the public focused on Wall Street excess, no senator has come forward to wield the knife. —*Dawn Kopecki*

The bottom line *With the public in an anti-Wall Street mood, Congress may do far more to rein in derivatives than anyone thought.*

Investing

Rising Profits Make Stocks Look Cheap

- **Optimistic analysts see big gains ahead for corporate earnings**
- **"A correction is going to come," warns a dissenter**

Although the market wobbled over worries about Greek debt, stock prices have been rising fast–and corporate profits have risen even faster. As a result, even after the biggest rally since the 1930s, U.S. stocks seem far from overpriced.

Analysts lifted their forecasts for profits in the year ahead for all sorts of companies, from consumer electronics maker **Apple** to railroad operator **CSX**, by 10 percent on average in April, the largest monthly increase since at least 2006. The Standard & Poor's 500-stock index is trading at 13.5 times forecasts for earnings during the next four quarters, a level many analysts find attractive.

Big investors such as **BlackRock** are snapping up companies whose results are most tied to economic expansion. "The stock market is incredibly inexpensive," says Kevin Rendino, who manages $11 billion for BlackRock, the world's largest asset manager. "I don't know how the bears can argue against how well corporations are doing."

Analysts expect S&P 500 companies to earn $86.89 a share in the next year, according to Bloomberg data. And they've been boosting their profit projections, in part because so many companies are beating estimates now. More than 77 percent of the 381 companies in the S&P 500 that reported first-quarter results by May 4 have topped estimates, Bloomberg data show.

There are other ways to look at the numbers. David Rosenberg, chief economist of money management firm Gluskin Sheff + Associates, says U.S. stocks are poised for losses because they've become too expensive. Using average annual earnings over the past 10 years–the method favored by Yale professor Robert J. Shiller, the price-earnings ratio of the S&P 500 was 22 on Apr. 30, the highest end-of-month figure since June 2008, and well above the long-term average of 16.4.

Economic growth will slow and stocks retreat as governments around the world reduce spending after supporting their economies through the worst recession since the 1930s, says Komal Sri-Kumar, chief global strategist at TCW Group. "The correction is going to come," Sri-Kumar said in an interview with Bloomberg Television on Apr. 21. "You now have a debt bubble growing on the sovereign side, and we're slow to recognize how negative that could be."

For now, though, corporate profits are pushing stocks higher. "The earnings story is very supportive of the market even after the rally over the last year," says Liz Ann Sonders, chief investment strategist at Charles Schwab. "The recovery is real, it's V-shaped, and it's got legs." —*Lynn Thomasson, Whitney Kisling, and Rita Nazareth*

The bottom line *If corporations keep piling up profits as rapidly as analysts expect, the stock market rally has a long time left to run.*

Quoted

"High-level executives are going to have to be removed from their positions both in the management suite and from the board of directors.... Goldman is going to have to pay a high price for its ineptitude. Its shareholders already have."
—Richard Bove, analyst at Rochdale Securities



33.7

BILLION DOLLARS

U.S. junk bond sales last month, the highest April total on record

DATA: BLOOMBERG

ILLUSTRATION BY SOPHIA MARTINECK. BOVE: MELISSA LYTTLE/THE NEW YORK TIMES/REDUX

Markets&Finance



Schmidt is seriously underpaid page 70 ▶

Banking

Société Générale Tries To Stage a Comeback



▶ The bank's books are still burdened by nearly $50 billion in toxic assets

▶ "It was the right strategy, but we could have carried it out better"

For Société Générale, the timing couldn't have been worse: On May 5, the same day that the French bank reported a $1.38 billion first-quarter profit, its most encouraging result in two years, Jérôme Kerviel struck again.

Kerviel, of course, is the junior trader who placed unauthorized bets on stock index futures and caused the bank to suffer a trading loss of some $6.5 billion in January 2008 when it unwound the deals. Kerviel, 33, has now published a book, *The Spiral: Memoirs of a Trader,* in which he says his Soc Gen bosses knew he was faking transactions and didn't stop him because he was making money for the bank. The bank expected traders to "obey, but know how to disobey," Kerviel says in the book. "Individualism and risk-taking reigned supreme."

Soc Gen declined to comment on the book. On its Web site, the bank says Kerviel "admits his misdemeanors ... but is seeking to use the weaknesses in the bank's control systems as proof of complacence or even encouragement by his superiors." Kerviel's trial on charges of abuse of trust, faking documents, and hacking into the bank's computers is set for June 8.

The book appears as Soc Gen is trying to reboot under Chief Executive Officer Frédéric Oudéa (pictured), having replaced much of its top management and spent $200 million to overhaul internal controls. "We have the means to be ambitious," says Michel Péretié, head of the investment banking unit, which saw first-quarter revenue soar to $2.8 billion, a 74 percent increase over last year's figure.

Péretié says he plans to increase the unit's head count by up to 10 percent this year as he pushes to boost its mergers and acquisitions business, boost revenue from operations in the U.S. by 50 percent over the next three years, and build a fixed-income franchise to match Soc Gen's global No.1 position in equity derivatives trading. "We are back to being a growth engine," says Péretié, a former Bear Stearns executive who joined Soc Gen in 2008. Soc Gen also is scouting acquisitions in emerging markets, especially Central and Eastern Europe; it already has extensive retail-banking networks in the Czech Republic and Romania.

Investors still need reassuring, though. Soc Gen shares are down 21 percent this year, the third-worst showing among 15 major Continental banks surveyed by Bloomberg. One big worry: the $48.5 billion in subprime and toxic assets still on the books. Soc Gen has taken nearly $12 billion in writedowns, including $310 million in the first quarter, and has said it may have to take as much as $1 billion more this year. Most other big European banks have largely finished cleansing their balance sheets, giving them resources to compete. Switzerland's UBS, for example, is hiring hundreds in its investment-banking business.

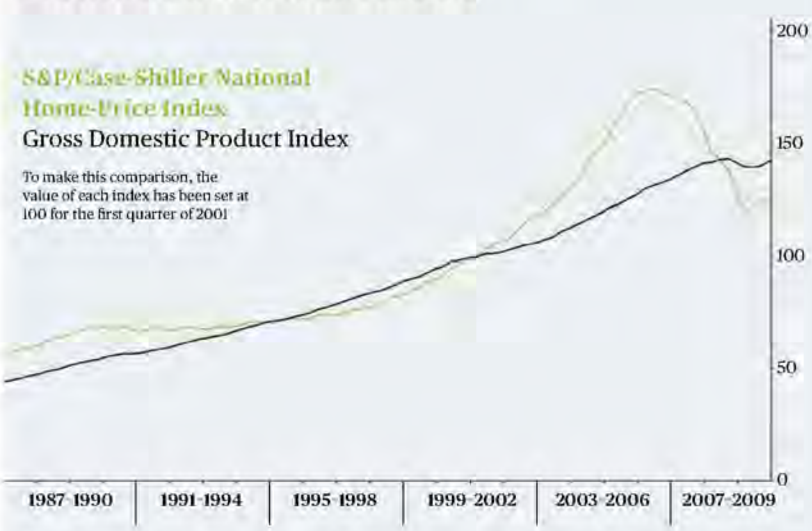
Publicity from the Kerviel trial, plus a class action filed in U.S. federal court by Soc Gen investors, won't make things any easier. Plaintiffs contend that Soc Gen not only failed to curb Kerviel's trades but also exposed the bank to outsized risks—for example, by buying $16.5 billion in credit-default swaps from American International Group, the most of any bank in the world. (Soc Gen recouped the loss when the U.S. government bailed out AIG.)

Some veteran Soc Gen executives now say the bank should have done more to control risk. "We gave precedence to the entrepreunial side," says deputy CEO Jean-François Sammarcelli, who joined Soc Gen in 1974. "It was the right strategy, but we could have carried it out better." —*Carol Matlack*

The bottom line *Soc Gen is trying to rebuild its reputation and its balance sheet, but Jérôme Kerviel and a backlog of bad assets are distractions.*

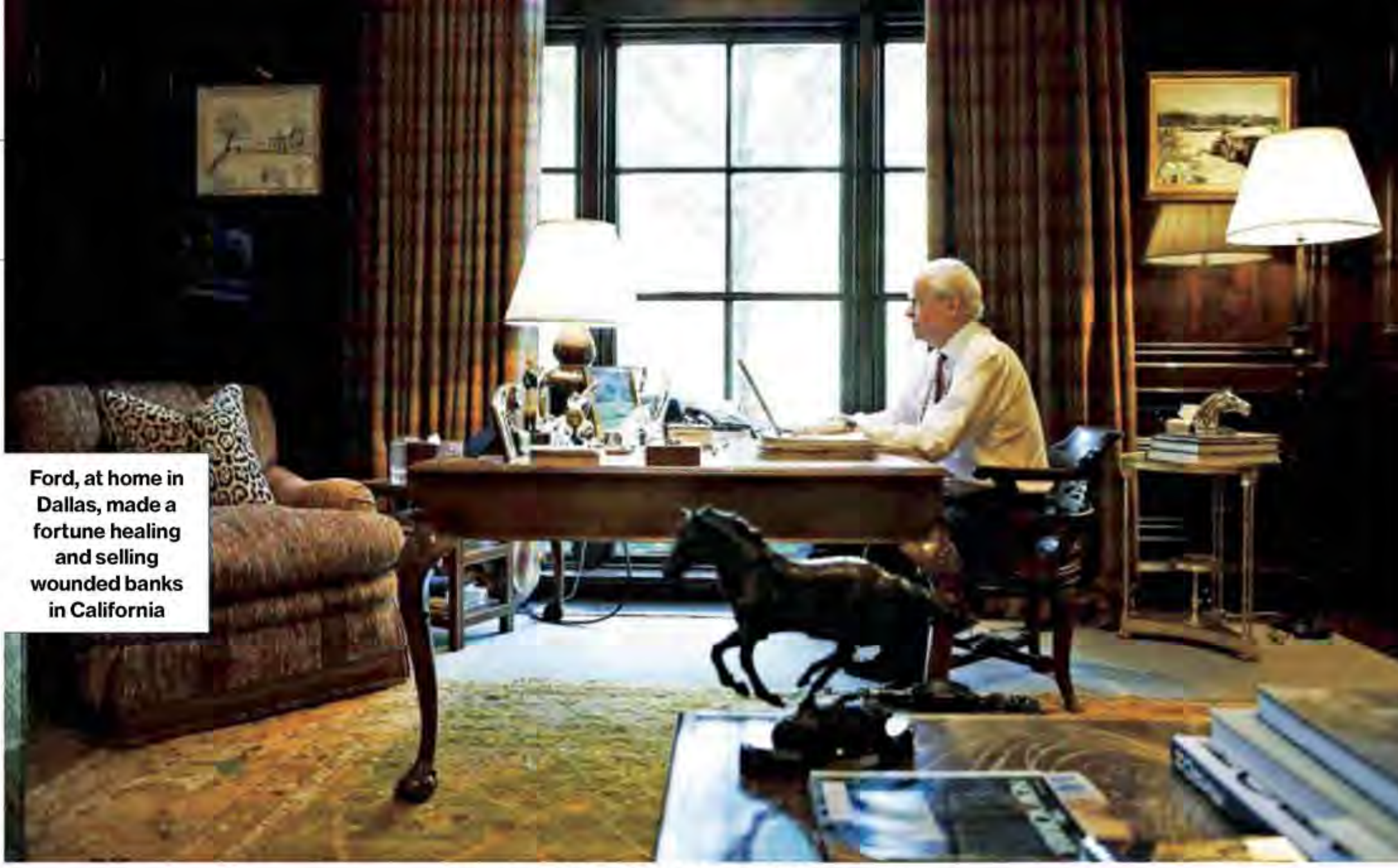
Real Estate

Homes Are Undervalued



Homes are now undervalued compared with the size of the U.S. economy. The chart, developed by St. Louis Fed President James Bullard and the bank's research economists, tracks the S&P/Case-Shiller National Home-Price Index and the value of gross domestic product before adjusting for inflation. By this measure, homes are the most undervalued in at least two decades.
—*Steve Matthews and Alex Tanzi*

DATA: FEDERAL RESERVE BANK OF ST. LOUIS



Ford, at home in Dallas, made a fortune healing and selling wounded banks in California

Rescues

A New Banking Bet for Billionaire Gerald Ford

- The veteran of the savings and loan crisis picks up Pacific Capital
- "We've been out there looking for a long time"

Bank investor Gerald J. Ford is placing a new bet on the industry that made him a billionaire. Ford, who built his private equity business by purchasing faltering lenders during the savings and loan crisis, said last week he will inject $500 million into Pacific Capital Bancorp for 91 percent of the troubled California lender.

Ford, 65, has something of a golden touch when it comes to turning around distressed banks. In 1998 he and a group of investors bought California's Golden State Bancorp and turned it into the second-largest savings and loan in the U.S. It fetched about $5.3 billion when he sold it to Citigroup in 2002. Ford walked away with more than 20 million Citigroup shares, which climbed 38 percent the next year to a value of more than $1 billion.

Santa Barbara-based Pacific Capital hasn't posted a profit since the first three months of 2008. In March the bank said that its survival was in doubt and that shareholders might be wiped out. The Federal Deposit Insurance Corp. is not offering any assistance to Pacific Capital, which is fine with Ford. He says the money he's provided, plus his experience in California banking, will help him revive the struggling lender. Ford bid unsuccessfully for several banks put on the block by the FDIC before agreeing to buy Pacific Capital. "We've been in the banking business on the West Coast before, and we liked it, and we think this is an outstanding franchise," he says. "We've been out there looking for a long time."

Ford, who is not related to the former U.S. President or founders of the U.S. automaking empire, entered the banking business in 1975 after receiving an economics degree and a law degree from Dallas-based Southern Methodist University, where a sports stadium is named after him. During the last banking shakeout in the 1980s, he and billionaire Ronald Perelman teamed up to acquire five debt-ridden thrifts, creating First Gibraltar Bank. They sold it in 1992. With part of the proceeds, they acquired San Francisco-based First Nationwide Bank from Ford Motor in 1994, transforming it from a money-losing lender plagued by bad real estate loans into a profitable statewide thrift. The two bought Golden State Bancorp in 1998, merging it with the rest of the empire.

Ford also knows when to sell. He set up a plan to unload chunks of his Citigroup shares if the stock price fell to certain levels. He told Bloomberg in 2008 that he mostly got out at 45 a share. Citigroup shares now sell at 4.55.

—*Nikolaj Gammeltoft*

The bottom line *With bank investments, Ford's timing has been excellent. Pacific Capital will put his turnaround skills to the test again.*

Housing

Strategic Defaults Are on the Rise



- When homeowners stop paying, where does the money go?
- It's "a form of stimulus, a little tax cut," says Zandi

The first wave of U.S. mortgage defaults was spurred by lenders who made bad loans and borrowers who wound up with larger monthly payments than they could ever hope to manage. Lately, something altogether different has been making an increasing contribution to soured debt: Americans choosing to stop making mortgage payments they actually can afford.

"Strategic" defaults accounted for at least 12 percent of all defaults in February, up from about 4 percent in mid-2007, according to a recent Morgan Stanley report. Analysts led by Vishwanath Tirupattur classified a default as strategic when a homeowner who hadn't previously been delinquent made an on-time mortgage payment one month; skipped payments for the next three

OPPOSITE: JACQUES BRINON/AP PHOTO. THIS PAGE: SCOGIN MAYO. ILLUSTRATION BY GREG MABLY

months; and stayed current on other consumer debt of $10,000 or more.

Housing analysts say strategic defaults mainly occur when a home's value has dropped below the balance remaining on the mortgage. A homeowner in that position may decide that continuing to make payments is throwing money away, or may default to get the lender to modify the loan. An estimated one in five U.S. homes with a mortgage has "negative" home equity, according to Zillow.com.

In March the Obama Administration announced it was coming up with a plan to encourage cuts to the principal on mortgages exceeding the worth of properties. Previous government efforts did not emphasize principal reduction but focused on lowering monthly payments.

Whatever you think of strategic defaults from an ethical point of view, they appear to be aiding the economy, temporarily, at least, by boosting consumer spending and allowing homeowners to stay current on their other bills. Consumer spending, which accounts for about 70 percent of economic activity in the U.S., rose at a 3.6 percent pace last quarter, more than economists forecast. The increase, the biggest since 2007, was somewhat puzzling considering that the underemployment rate was at 16.9 percent in March, near the highest level in at least 16 years. (The rate includes people without jobs, part-time workers who would prefer a full-time position, and people who want work but have given up looking.)

All told, borrowers who aren't making mortgage payments are probably skipping roughly $100 billion annually, an amount equal to 1 percent of consumer spending, according to Mark Zandi, chief economist at Moody's Economy.com. Zandi likens the money to "a form of stimulus, a little tax cut."

Not all of that "tax cut" is being spent on iPads, vacations, and lattes. "Presumably these homeowners know they're going to have to start paying again" to live somewhere, says Zandi. He suggests that falling delinquencies on credit cards and auto loans may be a sign that homeowners are using mortgage money to pay down other debt. Ⓑ

—*Jody Shenn*

The bottom line *By not making mortgage payments on "underwater" homes, borrowers may be paradoxically helping to boost the economy.*

Bid & Ask

$582mn



E-commerce

Priceline pitchman William Shatner has been transported to a new dimension—of wealth. Best known as Captain Kirk on *Star Trek*, Shatner's shares in the Internet travel site are now worth **$582 million,** according to a report in the *Toronto Sun.*



Art Market

A 1932 Picasso titled *Nude, Green Leaves and Bust* fetched **$106.5 million** at a Christie's sale of Impressionist and modern art in New York—a record for an art work sold at auction.

Real Estate

Billionaire Ron Burkle's Americold Realty Trust is seeking to raise **$600 million** in what may be the biggest U.S. initial public offering this year. With Greece-induced jitters dampening the IPO markets, Burkle's bankers knocked down the offering price range for the Atlanta-based real estate trust to $9 to $11 a share, from $14 to $16, and upped the number of shares on offer to 60 million.

Technology



Sales of Apple's iPad tablet computer hit the **1 million** mark just 28 days after its introduction, propelled in part by the Apr. 30 release of a new 3G version.



Mining

Europe's No. 3 aluminum maker Norsk Hydro is paying **$4.9 billion** for an assortment of assets owned by Brazil's Vale. As part of the deal, Norsk will assume control of the world's third-biggest bauxite mine, securing a supply of the ore that could last it a century.

Utilities

PPL, owner of Pennsylvania's second-largest utility, agreed to buy the U.S. power and natural gas unit of Germany's E.ON for **$6.7 billion** in cash, and the assumption of about $925 million of debt.

Buyouts

In the biggest buyout deal so far this year, private-equity firms Warburg Pincus and Silver Lake paid **$3.4 billion** for Interactive Data, a unit of Pearson that supplies financial market data and services

Theater

$4mn

The cost of the Broadway staging of *Enron*, a music, dance, and video extravaganza inspired by one of America's most infamous corporate scandals. The show—a hit in London—was panned in New York and closes on May 9 after a three-week run.

$44bn

Expositions

Visitors flocked to Shanghai's $44 billion World Expo, which opened to the public on May 1. The six-month-long fair is expected to attract some 70 million visitors, which is more than 10 times the number of attendees at the 2008 Beijing Olympics.



ART MARKET: RAMIN TALAIE/BLOOMBERG; MINING: AGE FOTOSTOCK; EXPOSITIONS: IMAGINECHINA/AP PHOTO


The greatest luxury in life is time.
Savour every second.
BREITLING
1884
BREITLING for BENTLEY
Power. Luxury. Exclusivity. Breitling and Bentley share the same concern for perfection. The same exacting standards of reliability and precision. The same fusion of prestige and performance. In the Breitling workshops, just as in the Bentley factories in Crewe, cutting-edge technology works hand in hand with the noblest traditions. Born from a passion for fine mechanisms, the Breitling for Bentley collection offers connoisseurs a rich range of exceptional chronographs. While conveying the quintessence of aesthetic refinement, these wrist instruments are all equipped with high-performance "motors", patiently assembled by watchmakers at the peak of their art. Time is the ultimate luxury.
The Bentley Motors Chronograph
30-second chronograph and variable tachometer (exclusive systems).
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Lessons

Poised for dramatic expansion, high-tech offshore drilling was considered ultrasafe. Then came BP's Deepwater Horizon disaster. What the company— and the industry—must do to bounce back

By Peter Coy and Stanley Reed





of the Spill

Last September, BP tapped into a vast new oilfield called Tiber, estimated to hold at least 3 billion barrels of crude, or six months' worth of U.S. consumption. Discovered through seismic imaging and data crunched on a supercomputer, the field is nearly six miles beneath the Gulf of Mexico's floor, in a spot where the water is almost a mile deep. To access it, the British oil company and its drilling contractor, Transocean, sank the deepest oil well ever known. The $365 million rig that accomplished this feat was called the Deepwater Horizon, a floating thicket of machinery the size of two football fields, which held a crew of 130 and cost more than half a million dollars a day to rent from Transocean. As a drilling rig, the Deepwater Horizon didn't hang around to pump Tiber's crude. The self-propelled behemoth motored to the site of its next exploration, a perfect expression of humankind's ability to find buried treasure deep beneath the ocean floor and bring it safely to the surface.

Today the wreckage of the Deepwater Horizon lies upside down at the bottom of the Gulf under a mile of seawater in a place called Mississippi Canyon Block 252. Eleven of its crew are missing and presumed dead. Oil from the last well it drilled—not Tiber, but a much shallower, less complex job called Macondo—is spewing out of control from the seafloor, with perhaps 3 million gallons released at last estimate. A swath of the Gulf about the size of Delaware is covered by an iridescent, rusty orange sheen.

If the spill comes ashore, as scientists say it is almost certain to do, it could cause damage rivaling the 1989 wreck of the Exxon Valdez in Alaska's Prince William Sound, despoiling the breeding grounds of countless species in the fragile coastal buffer zone that provides hurricane protection. Already, the oil is threatening some of the most productive and profitable shrimping and fishing grounds in the world, part of a Gulf industry that provides a quarter of the seafood in the U.S. If efforts to seal the well go awry, they could cause far larger volumes of oil to spill. In some scenarios, the Gulf of Mexico loop current could even carry the oil around Florida and up the East Coast. The unfolding environmental disaster might yet become the worst in U.S. history.

The Deepwater Horizon exploded on Apr. 20 at a moment when U.S. energy policy was pivoting decisively in favor of undersea drilling. After two years of fierce partisan debate triggered by the $4-a-gallon gasoline prices of 2008, President Barack Obama and other Democratic leaders dropped their opposition to expanded offshore drilling. On Mar. 31, Obama proposed opening up large areas of East Coast, eastern Gulf, and Alaskan waters beginning in 2012—part of a grand bargain that Administration officials hoped would propel comprehensive energy and climate legislation designed to lead the country beyond petroleum, as BP's slogan famously declared. All of that is now in doubt.

For the oil industry, the Gulf of Mexico had been one of the few bright spots in a dim picture of flattening global production. After several years of decline, the amount of oil pumped in the Gulf has been rising as rigs move into deeper waters. The U.S. Energy Dept. predicted this year that by 2035, offshore oil production from the Lower 48 states would grow more than 80 percent to account for about 38 percent of U.S. output, up from 30 percent now.

Until now, Gulf oil production has been not just expanding but reasonably clean, with serious spills so rare that industry and regulator alike behaved as if they were scarcely possible. Catastrophic accidents, it seemed, had been relegated to history by such high-tech gear as "blowout preventers" designed to shut off wells when pressures get out of control. These valves and shears were the last line of defense, a supposedly impenetrable Maginot Line that made other fail-safes unnecessary. The federal Minerals Management Service, which regulates offshore oil and gas production and collects reports on spills as small as a single barrel, was so confident of the system that it exempted BP from filing an environmental impact statement for the Macondo operation. MMS commissioned studies on creative ways to cope with massive well blowouts and never implemented them. It promulgated rules and allowed the oil industry to obey them on a voluntary basis. "It turns out, by the way, that oil rigs today generally don't cause spills," Obama said on Apr. 2. "They are technologically very advanced."

The Deepwater Horizon crisis has shifted the political conversation from seeking opportunity to avoiding risk. The Obama Administration announced a 30-day safety review. Florida Governor Charles Crist, who recently left the Republican Party to run for the U.S. Senate as an independent, backed away from his support for offshore drilling, as did California Governor Arnold Schwarzenegger. "It could have as big an impact as Santa Barbara," says Philip Verleger, an oil industry expert, referring to the 1969 oil spill off the California coast that was the catalyst for the first Earth Day in 1970.

Ultimately, no matter how many new regulations are passed, it will never be 100 percent safe to puncture holes in the ocean floor to drain out oil and gas. And until society manages to wean itself off hydrocarbons, offshore drilling will continue; the world needs the fuel. That said, advances in technology cannot be allowed to blind operators and regulators to the inherent risk. BP and its contractors were aware of other lines of defense. They just opted not to use them. As Mayor Tony Kennon of Orange Beach, Ala., told National Public Radio: "Why are we just now trying to figure out a Plan B? I think that bothers me more than anything right now."

The President on board Marine One with Admiral Thad Allen of the Coast Guard and Louisiana Governor Bobby Jindal (far right)



OPENING SPREAD: MICHAEL DEMOCKER/THE TIMES-PICAYUNE. THIS PAGE: PETE SOUZA/THE WHITE HOUSE/AP PHOTO. OPPOSITE: YURI GRIPAS/REUTERS



BP's Hayward (center) leaving the U.S. Interior Dept. on May 3

Tony Hayward, BP's chief executive officer, slid into a booth at Copeland's, a restaurant on the main drag of Houma, a southern Louisiana town of strip malls and honky tonks. It was May 2, some 12 days since the crisis began. His company had lost $30 billion, or 16 percent, of market value, and Hayward, over dinner with a Bloomberg News reporter, was not bothering with the obligatory CEO pose of absolute confidence and control. He was sweaty and haggard; he picked at his ravioli and only sipped his beer. The 52-year-old had been going flat-out for days, and despite his weariness, he retained the determination that won him the top job over a pack of rivals at the London-based oil giant. He repeated a phrase he says was coined by Winston Churchill: "When you are going through hell, keep going."

He was succinct about the future of offshore drilling. "It all depends on how successful we are with our response," he said. "If we deal with the situation in a way that minimizes the environmental impact, it will cause some debate. If the environmental impact is serious, as a consequence there won't be much, if any, extension of offshore drilling."

Hayward heard about the blowout at breakfast in London on Apr. 21, about four hours after it began; he says his first reaction was "unprintable." For the first few days he kept a low profile. BP judged that Transocean, owner of the drill rig, should take the lead. Later Hayward deferred to U.S. government agencies such as the Coast Guard. In early May, BP changed strategies and put Hayward in front of the cameras. The company hired Marine Spill Response to deploy four 210-foot oil-skimming ships and two planes to spray dispersants on the oil. As the crisis mounted, Hayward tried everything at once. The only problem was that, even at a cost of $7 million a day, none of it stopped the leak.

A mile below the surface, things can go to hell in an instant. The pressures and temperatures at work are otherworldly. Imagine an elephant sitting on your chest, and you get a small sense of the weight of rock and water pressing down on the reservoir of oil and gas miles below the surface. To keep the superheated, supercompressed fluids from shooting upward like a volcanic eruption before the well is finished, drillers fill the hole completely with a heavy, synthetic "mud." Then, to finish the well, they inject a high-tech cement. Each well requires its own unique formulation of mud and cement. The cement is supposed to go down the middle of the drill pipe—a seven-inch tube surrounded by a larger pipe called the casing. When it reaches the bottom of the drill pipe, it oozes up into the gap between the pipe and its casing before drying in place, forming an impenetrable seal.

At least, that's what's supposed to happen. The Deepwater Horizon accident occurred at the final stage of the job, as the rig crew was preparing to put a temporary seal on the well and move on to another site. The exact circumstances aren't likely to be known for months, though it's clear that pressurized natural gas was able to infiltrate upward, meaning the seal was imperfect. It's the same thing that happens when you crack open a soft drink and tiny bubbles of carbon dioxide expand and rise—the difference being that natural gas is explosive. Mistakes like this are not rare. A 2007 MMS study found that cementing was a factor in 18 of 39 Gulf of Mexico blowouts over 14 years. The pressure surge from a gas bubble even has a nickname: the kick. There are procedures for recementing, but those take time and money; each extra day of leasing the drilling rig costs about $500,000. Halliburton was in charge of cementing,

Forecast of deepwater Gulf oil production as share of total U.S. oil production

Share	Year
15%	2002
30%	2013

DATA SOURCE: ENERGY INFORMATION ADMINISTRATION



Fisherman hired by BP lay oil booms to stop the spill from spreading

under BP's direction. Robert MacKenzie, a former cementing engineer who is now a securities analyst for FBR Capital Markets, says he wants to know whether BP ordered a so-called cement bond log test to evaluate the cementing. Such a test would have determined whether or not a remedial cement job was necessary. BP declined comment.

When all else fails, the last line of defense in a subsea well is the blowout preventer, which uses valves to close off the flow of oil and gas if pressures get too high. If the regular valves fail, the doomsday feature of the blowout preventer is a series of shear rams–essentially giant pairs of hydraulically powered scissors that are supposed to close off the opening by slicing through all the pipes. The pressure the shear ram can exert is greater than the pressure on the struts of a landing, fully loaded Boeing 747 as the rear wheels hit the runway, says Satish Nagarajaiah, a Rice University professor of mechanical and civil engineering. The Deepwater Horizon's blowout preventer had five hydraulic rams. For reasons that are still unknown, they didn't do the job.

The blowout preventer, made by Houston-based Cameron International, failed to close off the flow of oil and gas. The gas came up the pipe to the rig and then, heavier than air, settled in low spots. Survivors later said they heard a thump, then a hissing. The mammoth rig began to shake, and explosions began at about 10 p.m. on Apr. 20, sending flames hundreds of feet into the air. To Captain Michael Roberts, a commander of a supply vessel that arrived just a few hours later, "it appeared as if the sun was coming over the horizon," he told CNN. Nearly two weeks after the accident, rescue crews still had not managed to get the blowout preventer working. "We have found that there are some leaks on the hydraulic controls" of the blowout preventer, Bob Fryar, senior vice-president of BP's exploration and production operations in Angola, in southwestern Africa, told the *Houston Chronicle*.

Hayward said he was mystified that the blowout preventer failed, though failure isn't a rare event. The last-ditch shear ram is rarely tested under real conditions because of the destruction it causes. In a 2002 laboratory test for MMS, researchers found that three of six shear rams failed. Seven other makers declined to be tested.

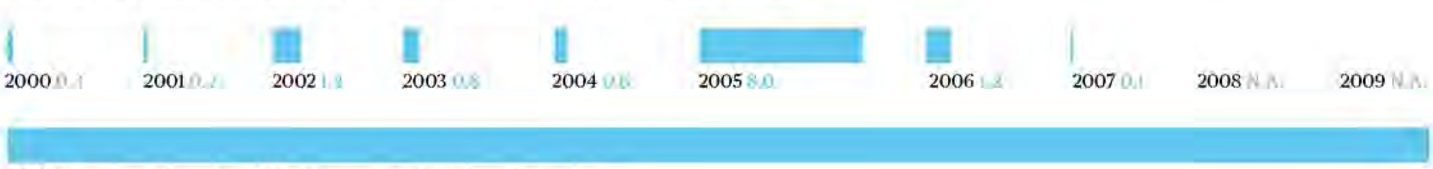
Within a day of the accident, BP had sent as many as eight underwater robots to the scene. Hayward and other company executives watched from a special room inside the company's suburban Houston complex as the robots, which look like sleds and are painted yellow to be visible at ocean depths, did their work. Tethered to a mother ship by wire, they fed video images to their pilots, who use joysticks to move the vehicles and manipulate their tool arms. BP executives hoped the robots could pull external levers and get the blowout preventer to snap shut. A BP spokesman says the company no longer expects the robots to get the device working.

That doesn't mean they are being put back in their boxes. Robots are the only eyes and ears that BP and other responders have below the sea. The company uses them constantly to monitor the wellhead and mile-long length of pipe that has fallen to the bottom of the Gulf. BP and its contractors are now deploying the robots in a new attempt to shut down the undersea leaks. The company is constructing a four-story steel funnel that it will try to lower over the most serious of the three. Once the device is in place, a cap attached to a pipe will be placed on top. The hope is that the captured oil, which is lighter than water, will rise up the pipe to a special surface vessel where it can be separated from water and disposed. BP estimates that if successful, the funnel could divert 85 percent of the oil flow. On May 5 the company succeeded in stopping the smallest of three leaks, a dribble from an oil-filled section of pipe that had broken off.

As the spill spread, BP assembled at least nine airplanes and hundreds of ships for cleanup. Its logistics base for the Gulf of Mexico, in Houma, has been turned into a command center where uniformed U.S. Coast Guard personnel mingle with specialists from BP and other oil companies such as Exxon-Mobil. "There is no expense spared," says Jacqueline Michel, president of Research Planning, an oil-spill consulting firm based in Columbia, S.C. One fear: Because oil is still flowing,

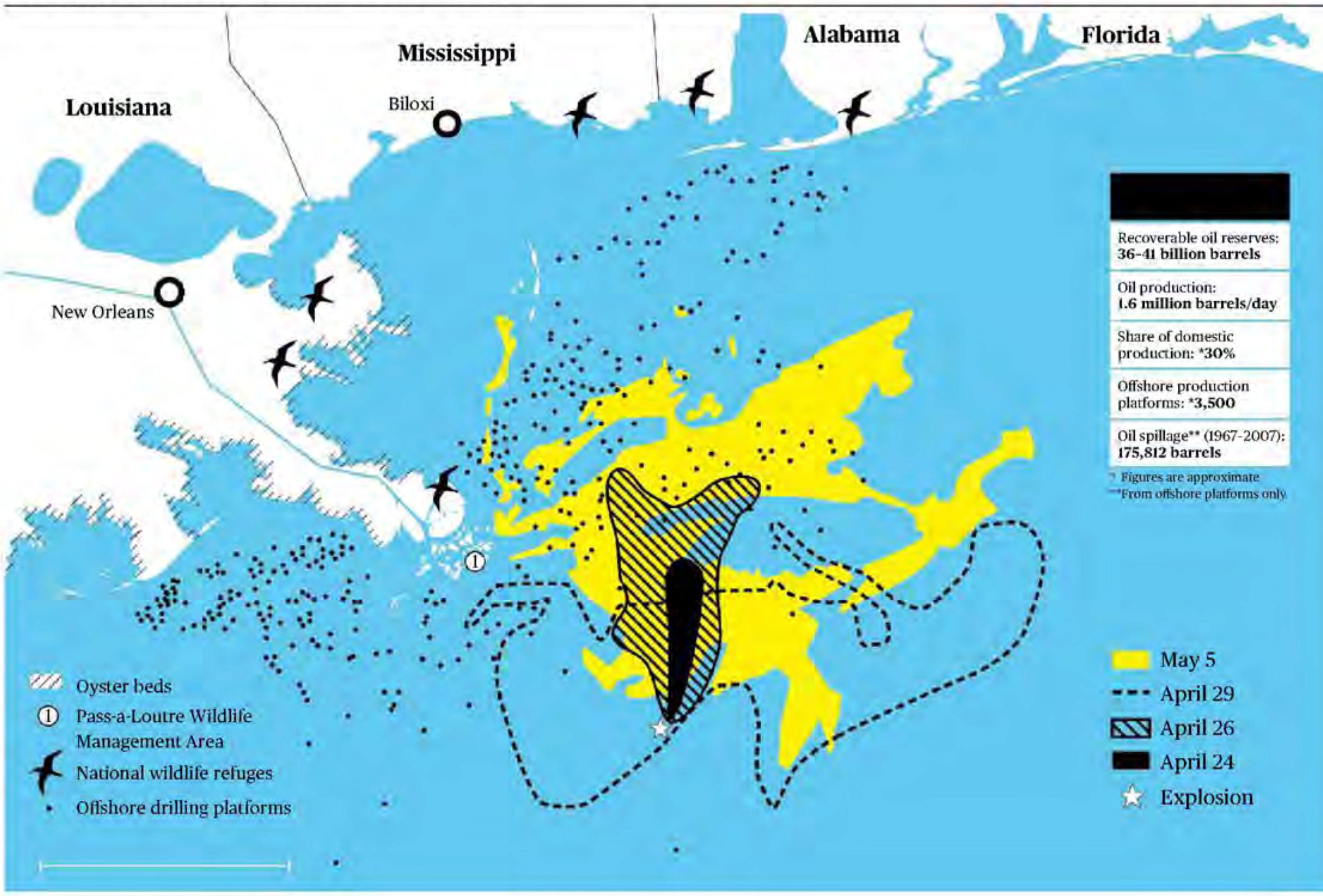
A COMFORTABLE SAFETY RECORD—THEN DISASTER

Annual oil spills from U.S. offshore platforms (In thousands of barrels)



Data: American Petroleum Institute, BP

THE PATH OF THE SPILL IN THE GULF OF MEXICO



a cleanup exercise might be in vain—and even damaging to the most fragile areas, because it might have to be repeated.

Before the accident, Hayward seemed to have BP on the right track after succeeding his mentor John Browne, who resigned amid personal scandal in 2007. Browne did the megadeals—a $62 billion merger and acquisition of Amoco in 1998, a $32 billion deal with Arco in 2000—that propelled BP into the supermajor class. Yet the company during his tenure was hopelessly accident-prone in the U.S., its most important operating area. In 2005 a blast at a BP refinery in Texas City, Tex., killed 15 people and injured more than 180. In 2006 oil leaking from a pipeline forced BP to shut down part of its key Prudhoe Bay oilfield in Alaska. Hayward has improved BP's safety record, accelerated much-delayed projects, and backed away from some of Browne's investments in alternative energy that Hayward deemed uncommercial. Profits more than doubled for the quarter ending Mar. 31, to $5.6 billion.

$8bn

Estimate of worst-case pretax cost to BP from the Macondo spill

More than any other major, BP has staked its future on aggressive projects in the deepwater Gulf. "We don't do simple things," said Andy Inglis, the company's exploration and production chief, in an interview last summer. "We are prepared to work on the frontier and manage the risks." Using seismic imaging techniques, BP made big discoveries including Thunder Horse, now the second-largest producer in the U.S. at about 300,000 barrels per day. Last September's Tiber discovery was one of the world's most important for the year.

The Macondo prospect, where the accident occurred, was a much simpler job than Tiber. The well was only half as deep. Hayward insisted the accident was the fault of the drilling company, Transocean, not BP. "It is not our rig, not our equipment, not our systems," he told the BBC on May 3, before edging toward a recognition of political reality. "There may be a need to do more oversight of drilling equipment," he said at dinner.

Clearly, the industry and its regulators will have to revisit how they operate. Inquests into the Deepwater Horizon disaster may find that complacency played a crucial role. Take one example: The four-story-tall steel funnel that BP fabricated in Port Fourchon, La., and plans to lower over the largest of the three leaks, was not expected to be operational until three weeks after the accident. Shouldn't the industry already have several such chambers on standby in offshore drilling regions? This isn't exactly a fresh idea: In 1979, Brown &

OPPOSITE: GERALD HERBERT/AP PHOTO DATA SOURCE: SANFORD C. BERNSTEIN & CO

Root lowered a 40-foot-wide "steel sombrero" over the blowing Ixtoc I well in the Bay of Campeche, Mexico, which spilled 35 million barrels before the sombrero helped stanch the flow.

10mn

Projected global deepwater oil production capacity in barrels a day. Up from 1.5 mn in 2000

Over the years, researchers funded by MMS have proposed a variety of ideas for coping with well blowouts; none has gotten past the drawing board. In 1985, Brown & Root recommended that an oil tanker be retrofitted to collect huge volumes of oil and seawater funneled from a blown well and to pump the liquid into separating tanks. Estimated cost: $59 million. Without commenting on the merits of that particular idea, industry consultant Robert Peterson says it's common for the industry to neglect promising innovations. "The transfer of the technology from the lab to a commercial application is where you see the highest mortality rate in terms of good ideas," says Peterson, a Houston-based oil and gas expert at Charles River Associates. A spokesman for the Minerals Management Service did not respond to questions about past research.

One reason for complacency is that MMS's own statisticians never flagged the possibility of a serious spill. By design, the department's Oil-Spill Risk Analysis model focuses on the likely frequency of spills rather than how big one might get. Projecting from the history of small spills over the past several decades, MMS in 2007 predicted just five spills of 10,000 barrels or more per 100 billion barrels of oil produced. Ten thousand barrels is about what the Macondo well is thought to be leaking every two days. The routine spills that MMS used to calibrate its prediction model "have no bearing on dealing with major spills, predicting their frequency, or getting ready for them," says Zvi Ziegler, a mathematician at the Technion-Israel Institute of Technology in Haifa, Israel. The MMS press office did not return calls asking about the agency's statistical methodology.

Critics of MMS have repeatedly called it a captive of the companies it regulates. Last September the Interior Dept. shut down an oil royalty program run by the agency after audits found that MMS was undercollecting millions of dollars worth of royalties.

THE TEN WORST OFFSHORE PLATFORM BLOWOUTS

Date	Name of Platform	Location	Volume of oil released*
June 1979	Ixtoc I	Bay of Campeche, Mexico	3,500,000
Oct. 1986	Abkatun 91	Bay of Campeche, Mexico	247,000
Apr. 1977	Ekofisk Bravo	North Sea, Norway	202,381
Jan. 1980	Funiwa 5	Forcados, Nigeria	200,000
Oct. 1980	Hasbah 6	Persian Gulf, Saudi Arabia	105,000
Dec. 1971	Iran Marine Intl.	Persian Gulf, Iran	100,000
Jan. 1969	Apha Well 21	Pacific, Calif., U.S.	100,000
Apr. 2010	Deep Water Horizon	Gulf of Mexico, U.S.	70,000**
Mar. 1970	Main Pass Block 41	Gulf of Mexico	65,000
Mar. 1970	Yum II/Zapoteca	Bay of Campeche, Mexico	58,643

*Estimate in barrels **As of May 5 Data: American Petroleum Institute

The Interior Dept. inspector general's office found that several MMS officials had "frequently consumed alcohol at industry functions, had used cocaine and marijuana, and had sexual relationships with oil and gas company representatives." In the latest embarrassment, BP was one of three finalists for the agency's annual safety award for major offshore producers. The ceremony, scheduled for May 3 at a conference in Houston, has been postponed.

Even with MMS as its minder, BP felt threatened by overregulation. In a letter to regulators last September, Richard Morrison, the company's vice-president of Gulf of Mexico production, wrote to oppose new rules meant to reduce the risk of injuries and spills, saying that voluntary programs "have been and continue to be very successful."

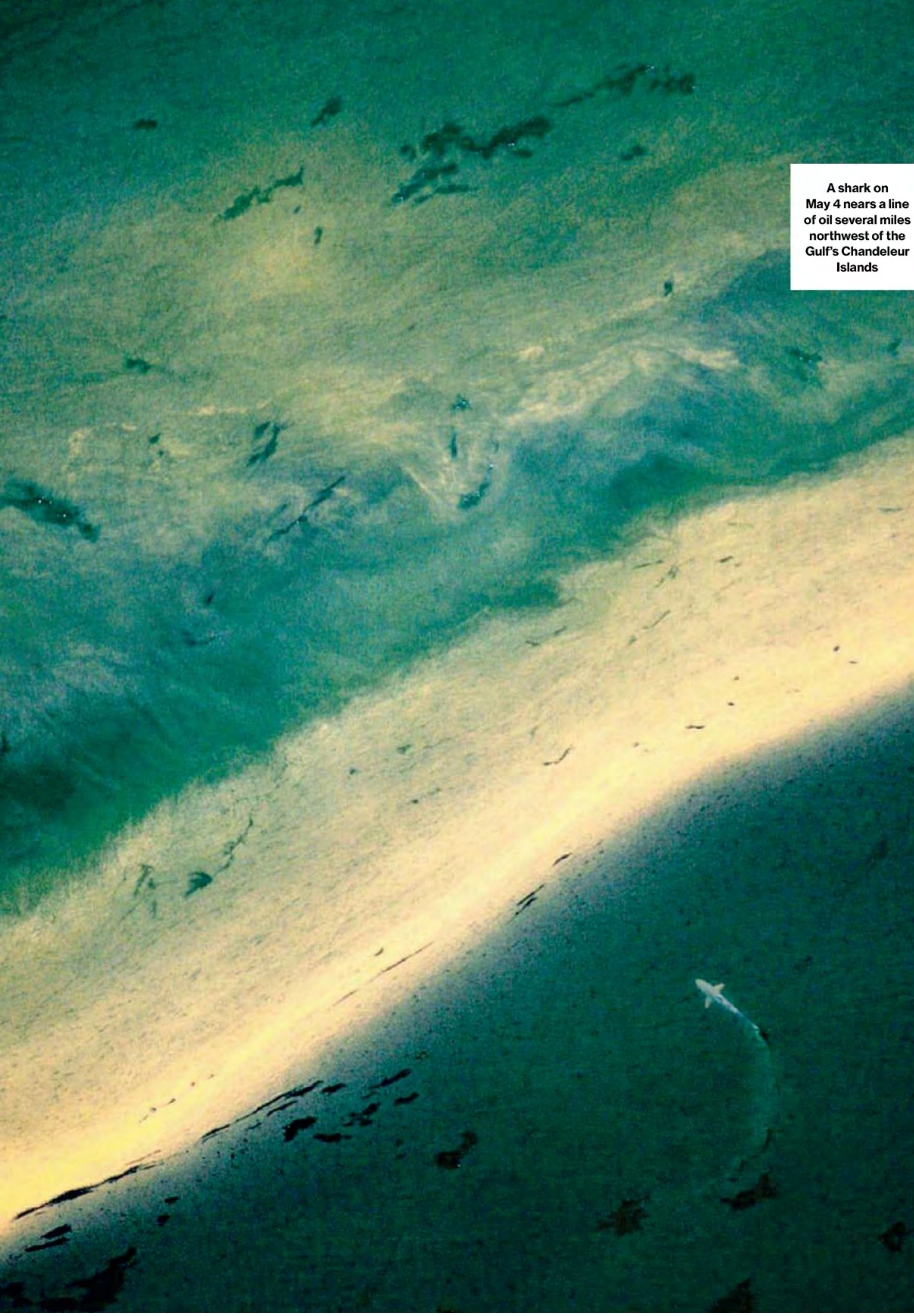
The biggest question now is unanswerable: whether the Macondo blowout was a fluke in an otherwise safe system or an indication of more trouble to come. Earlier this year, 19 members of Congress wrote to MMS asking for its response to accusations by an anonymous former contractor that BP did not complete crucial engineering drawings and other paperwork for subsea components of its Atlantis project, which began producing oil in 2007. The ex-contractor supplied what he claimed were internal BP e-mails expressing concern about the incomplete documentation. In one such e-mail made public by the self-proclaimed whistleblower, a BP executive on the Atlantis team named Barry C. Duff writes that the incomplete documentation "could lead to catastrophic Operator errors." Food & Water Watch, the organization that publicized the accusations, has refused to release the whistleblower's name to the news media at the person's request. An MMS spokesman declined to comment on the allegations. In a Jan. 15 letter to the House subcommittee on energy and minerals, BP did not dispute the authenticity of Duff's e-mail but denied that it had mismanaged records or jeopardized the project.

Some of the industry's most reliable supporters have been taken aback by the Macondo spill. "This is like a nuclear plant going out of line; it is too risky for the environment," says Nansen Saleri, a former chief of reservoir management at Saudi Aramco. "This should be a lesson to learn and improve; offshore resources are too important to be written off."

Thus far President Obama has not backed off his proposal to expand offshore drilling. Aides say the Administration is using the 30-day safety review to devise rules that could make offshore drilling safer and, perhaps, rescue his delicate compromise of more drilling along with more efforts to boost clean energy and combat global warming. Regardless, the crisis is likely to further splinter an already skeptical Congress. Senator Frank Lautenberg (D-N.J.) is leading a drive to increase the industry's liability for economic damages, which is currently capped at $75 million per incident. As for BP's Hayward, he will need both savvy and luck to avoid having this incident define his tenure, just as the Texas City refinery explosion defined his predecessor's. Noting that he has spent his first three years as CEO restoring BP's fortunes, Hayward says: "My task for the next three years is to put this event behind us."

—With Joe Carroll, Jim Efstathiou Jr., Hans Nichols, Jim Polson, and Jessica Resnick-Ault

DATA SOURCE: IHS CAMBRIDGE RESEARCH ASSOC
CHRIS GRANGER/THE TIMES-PICAYUNE



A shark on May 4 nears a line of oil several miles northwest of the Gulf's Chandeleur Islands

Google's search results page is one of the most important pieces of real estate on the Internet. Even tiny changes have a huge impact on profits. So would you trust these guys to redesign it?



Product manager Nundu Janakiram (left) and Web designer Jon Wiley
Photograph by Bryce Duffy



Google did

By Helen Walters

Every day 268 million people use Google to search for something. The query goes in, the company's software delivers back the most relevant links. The interaction is so simple—and the hidden calculation behind the results so complex—that it's no wonder people tend not to notice much about the process. Who bothers to ask the ingredients of a magic formula?

For all of its experiments with maps, books, e-mail, and social networking, Google is still an empire built on search. Ninety-seven percent of the company's $23.7 billion haul in 2009 came from advertising. While Google doesn't break out what each of its individual ad products such as AdWords or AdSense generates, multiple people within the company concede that Google is as dependent on the "Sponsored Links" generated by search queries as an oil nation is on its wells.

Since Google's 1998 debut, the search results page—where a home page query is returned with 10 suggested links on the left and multiple advertiser links on the right—has been through seven subtle redesigns. The most recent, in May 2007, saw the addition of images and video in what was dubbed "universal" search. On May 5, Google unveiled its eighth iteration, which Marissa Mayer, vice-president of search products and user experience, calls "particularly large and particularly important."

Google has long had advanced search capabilities, but they were difficult to find. The goal of redesign eight was to surface them and integrate them into the main results page. Users now get results with an extra column of tools to drill deeper into information. That means a query can be quickly refined to show only results from shopping sites, say, or just videos on a topic, or the latest news results. Add in a new logo and a splash of colorful icons on the left side of the page that guide users through the new options, and the look is noticeably different (right).

Given that the shift of a few pixels can affect Google's profits, why would the company ever mess with the most successful product in the history of the Internet? "The Web is always changing, evolving, and innovating," says Mayer. "It's important even for sites that people use every day and are very familiar with, like Google, to update their look."

It's not just the look that's been updated. Microsoft's Bing and social media sites such as Facebook and Twitter have made a case for the past few years that Google's search, based on ranking the overall relevance of a Web page, is outmoded, and that the future lies in an integration of relevance with real-time search. In December, Google conceded the point and announced it would begin indexing the Web in real time to help users organize the cacophony emanating from social media.

Some in the search industry are skeptical of introducing such complexity to the results pages. "Advanced search almost never works," says Jakob Nielsen, principal of the Norman Nielsen Group and co-author of the book *Eyetracking Web Usability*. "People don't want to use a search engine. They want to get away from a search engine. That's the reason the advertising works so well—the search engine is one site they want to get away from so they might go to an advertiser." In other words, Google has thrived precisely because it hasn't tried to envelop its users in a full-frills experience.

Still, the competitive landscape is changing. In March, Facebook surpassed Google as the most visited Web site in the U.S. Microsoft has unveiled its own plans for Bing, which currently comes in a distant third in the battle for eyeballs but is making a play in searches along topics such as travel and shopping. Bing recently rolled out a design that adjusts the user interface of search. So if it's clear a user is looking to buy a plane ticket, Bing morphs into a travel engine. "It's a very radical departure from the dominant paradigm of the link-based system on the Web," says Stefan Weitz, director of Bing. "For every query, presenting results back with the same user experience doesn't make sense. You want to book a flight or track a flight, why display a bunch of links? That's illogical."

All the tweaks Google has made complicate its algorithm—and none of them can be allowed to complicate its interface. "They have to try to continue to innovate and evolve the product but stick to keeping things simple," says Andy Miedler, senior technology analyst at St. Louis investment bank Edward Jones. "People have grown to love the simplicity of Google." Every previous redesign has negotiated the demands of simplicity and complexity while improving Google's bottom line.

Google allowed *Bloomberg Businessweek* access to the core design team of 16 staffers in March, as the company was fixing bugs and gearing up to roll out the redesign—a process marked by collaboration between people who create wild illustrations with dry-erase markers and mathematical types who write in precise code. The atmosphere was loose, though the pressure of the job—engage the new decentralized, socialized Web while still driving users to the advertisers paying the bills—generated its share of stress. "There's a lot of weight associated with the project," says product manager Nundu Janakiram, the point person between engineering, design, and the five other departments involved in the project. "Everyone feels invested in the search engine; it ties together the company. We have to get this right."

"Everyone feels invested in the search engine; it ties together the company. We have to get this right"
Nundu Janakiram

Every Google page must work seamlessly on countless different computer makes, connection speeds, browsers, and screen sizes. It also must be optimized to keep people searching and clicking as fast as possible. Just thinking about the technical requirements can drive designers mad. So when the team assigned to Search Results V8 first gathered in the summer

COURTESY OF GOOGLE

How Google Got Its New Look

The design process that led to changes in the all-important search results page

1. Branding matters
The Google logo loses its drop shadows and TM symbol.

old

new



2. Side navigation color
In an early experiment, blue columns frame the results. The idea is rejected.



3. Search query box
The length is extended to better establish the width of the results page.

4. Search query box color
Turning the search box blue creates a needless distraction. In the final design, it's gray.

5. Links are no longer underlined
Secondary links have their underlines removed to cut down on visual clutter. Designers want to remove more link lines, but tests show this confuses users.

6. Some things don't change
The extendable "Goooooogle" icon at the bottom of the search results page is considered sacrosanct.





7. Text: Flush left or right?
Designers try aligning text on both the left and right sides of the toolbar. Final decision: Flush left.

8. Toolbar: Flush left or right?
The placement of the tool bar is tested exhaustively before usability experiments show the eye pays more attention to the left side of the Web page.

9. "Something Different"
A new function meant to encourage "sideways search"—a way for users to investigate similar queries. Originally labelled "Not Entirely Unlike" (a tribute to science fiction writer Douglas Adams), the name is changed before launch to avoid confusion.

10. But wait, there's more
The page highlights tools that Google's algorithm determines might be useful.

11. Redundancy is O.K.
Designers include text *and* icons for images, news, etc., for clarity's sake. Even though some of the links appear twice, the team decides that duplication is better than removing a familiar tool.

12. Pixels matter
White space is added between the search box and the first result after it is determined the increased gap wouldn't slow down click rates.

of 2009 in a small room at Google's Mountain View, Calif., headquarters, they opted not to think about requirements at all.

Janakiram, a 24-year-old Stanford grad, Web designer Jon Wiley, a 34-year-old ex-improv artist, and two visual designers mocked up hundreds of different results pages that turned everything users know about Google inside out. "Anything we could move around, we moved around," says Janakiram. Navigation tools were switched from the left to the right side of the screen. Colors changed from Google's muted blue to variations with Crayola-like vibrancy. Link styles got tweaked and modules were inverted. One proposal crammed every pixel on the page with information. Another added display advertising.

The wild-ideas phase was a good mind-clearing exercise—and mostly just that. When it came time for the designers and engineers to move into a larger space together and get serious about the new look, the exigencies of reworking one of the world's most profitable Web pages couldn't be held off. "We tend to focus on an evolutionary model where you can bring users along with you vs. dropping them into some completely radical experience," says Wiley, who once ran the Web operation for Texas Governor Rick Perry and who joined Google in November 2006. The engineers try to view themselves as enablers rather than wet blankets. "Sometimes a designer will tell you what they want, and you'll tell them you can give them 90 percent of that with a quarter of the work," says Nate Gaylinn, the technical lead on the project. "If it's really worth it to have the right experience, then you have to put in the extra work. But if it's a minor detail that you can argue either way, we'll take the easier route."

Most of those details are hashed out at a daily "stand-up" meeting of 10 people or so, held at 4:07 p.m. (Google co-founder Sergey Brin once estimated that it took seven minutes to walk across the Google campus; it's now company tradition that meetings end on the hour and new ones start seven minutes later.) Everyone working on the project gathers standing up, to make sure no one gets too comfortable and no time is wasted during the rapid-fire update. Janakiram, balancing a keyboard on the back of his chair, takes notes throughout. "The whole concept of the stand-up is to talk through what everyone's doing," says Gaylinn. "So if someone's working on what you're working on, you can discover and collaborate, not duplicate." Every proposed feature is put through a user interface review conducted by members of the larger search team, who work nearby and police proposed changes to make sure they won't have an unfavorable impact on the search-engine infrastructure. "They're making sure we don't screw up," says Gaylinn.

By October 2009 the team had its first functional prototype ready for "dogfooding"—in which all of the company's 20,000 employees can opt to test a new product. The internal focus group members can log bugs or simply comment on the design. Google won't say how many staffers took part, nor will it release the text of any comments. Janakiram will reveal that at its peak the team received a piece of feedback every 10 seconds and that not all of the responses were helpful. Even Google employees, he says, will send a message to let designers know they think their work is terrible.

One immediate focus of the feedback was the search

Home Page Evolution

Since the day Stanford computer science graduate students **Sergey Brin and Larry Page** registered the domain Google.com —Sept. 15, 1997, if you're curious—the search results page has been redesigned seven times. The iconic home page has also undergone its share of tweaks.



Nov. 11, 1998
The jaunty launch design makes copious use of exclamation points and boasts an index of around 25 million pages.



Nov. 6, 1999
Goodbye exclamation points. Users now have the ability to drill into government documents or find out about jobs at Google.



May 10, 2000
The world map signals Google's availability in 10 languages, accessible via a drop-down menu to the right of the search box.



Mar. 31, 2001
A centered logo and uncluttered page—confident gestures befitting the world's largest search engine.



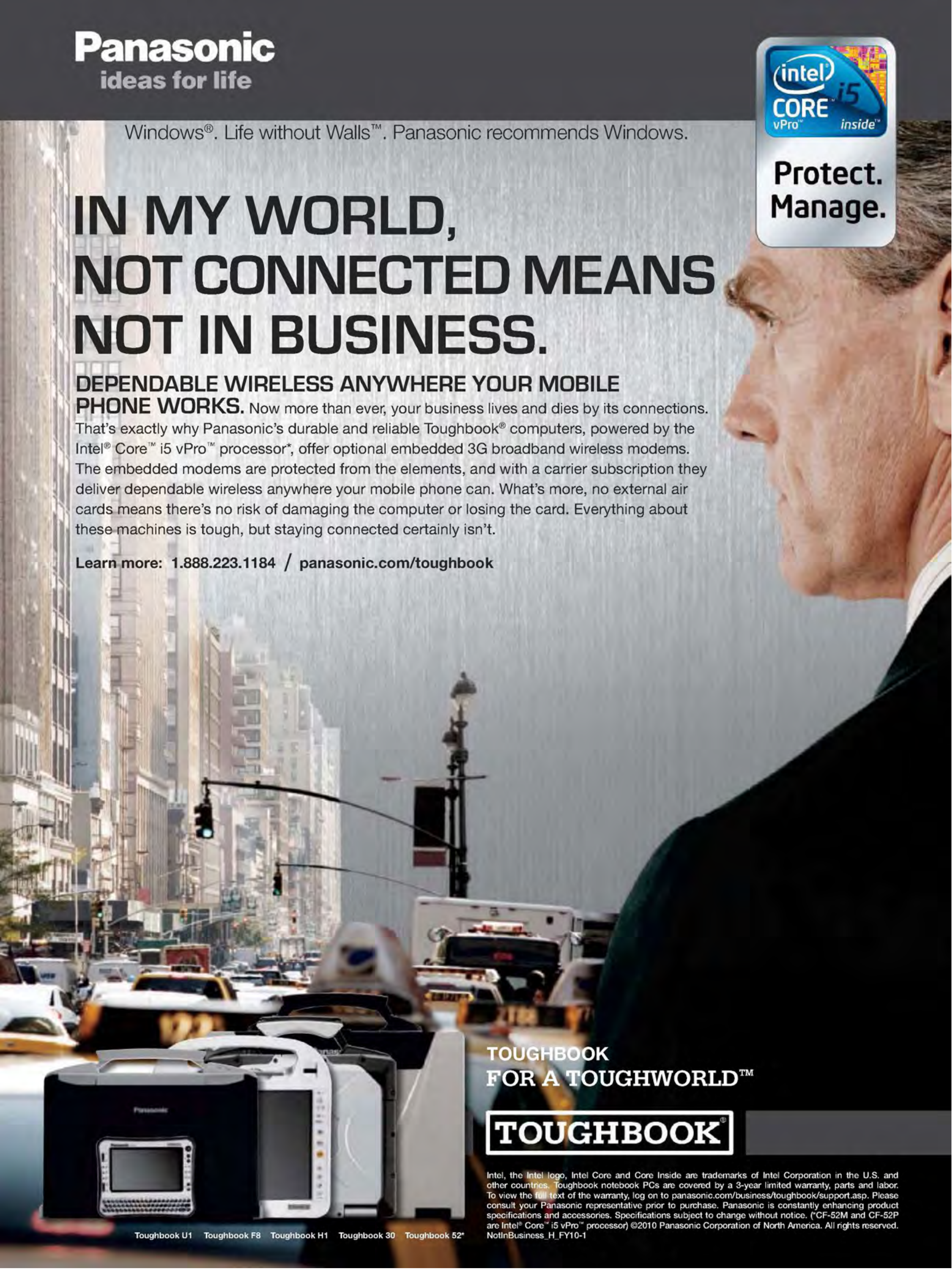
Mar. 25, 2004
Links to Google products such as News and Groups are added above the search box.



Oct. 12, 2007
Google becomes available in Arabic. Currently, the search engine is available on 157 domains and in 117 languages (including Klingon.)



Dec. 2, 2009
In an attempt to pare back distractions, the most recent change removed most of the icons, which appear only when a user initiates the mouse.


Panasonic
ideas for life
Windows®. Life without Walls™. Panasonic recommends Windows.
intel CORE i5 vPro inside
Protect. Manage.
IN MY WORLD, NOT CONNECTED MEANS NOT IN BUSINESS.
DEPENDABLE WIRELESS ANYWHERE YOUR MOBILE PHONE WORKS. Now more than ever, your business lives and dies by its connections. That's exactly why Panasonic's durable and reliable Toughbook® computers, powered by the Intel® Core™ i5 vPro™ processor*, offer optional embedded 3G broadband wireless modems. The embedded modems are protected from the elements, and with a carrier subscription they deliver dependable wireless anywhere your mobile phone can. What's more, no external air cards means there's no risk of damaging the computer or losing the card. Everything about these machines is tough, but staying connected certainly isn't.
Learn more: 1.888.223.1184 / panasonic.com/toughbook
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NotInBusiness_H_FY10-1

button: The designers had turned it blue. "We got a lot of people telling us they found the button distracting, or they usually hit enter to search, or their gaze was going to the box, not the results," says Janakiram.

In addition to dogfooding, Google researchers ran 19 test subjects through hour-long eyetracking sessions to monitor responses to various aspects of the new design. Eyetracking has come a long way since the early 20th century, when objects were glued to a test subject's eyeballs. Now multiple cameras are built into computer screens, and the technique provides detailed analysis of where someone browsing a Web page is actually looking. Users often read Web pages as two lines across the top followed by a vertical stripe down the left side of the screen, in what's known as the "F-pattern."

During eyetracking, the engineers and designers sat in an adjoining room and gawked through a two-way mirror while users tried out various incarnations of the new search results page. Each participant was given prescribed tasks to search for so that the Google team could see the page in action. In a test staged during *Bloomberg Businessweek*'s visit, a user was told to imagine his niece was writing a report about Michael Jackson, and he was tasked with helping her find specific information. When users got distracted–as they were by the same blue search button the dogfooders objected to–or failed to grasp how they were supposed to interact with the page, it meant it was time to scrap an idea. In other instances eyetracking data helped designers decide between different colors and type sizes.

While the engineers and designers pored over eyetracking results, Google statisticians conducted months-long experiments with hundreds of thousands of live users. (One advantage of having 268 million users a day is that you can roll out new products to a fraction of them and still have the benefits of a large sample size.) Google wants more searches and more clicks on its Sponsored Links, and anything that slows the process or inhibits clicking can have disastrous effects on profits.

Toward the end of the redesign process the statisticians focused on the slightly expanded gap between the Google search box and the first result. "No human being will notice they spend on average 10 milliseconds longer to click on a search result," says software engineer Patrick Riley. "But if all users take 10 extra milliseconds, we need to be concerned." This analysis was fed back to the designers, who adjusted accordingly. "We take the quantitative and qualitative feedback together with our own intuitions about how the search results pages should be working, and we iterate on the design," says Janakiram.

The focus on metrics is a deeply ingrained part of Google's culture. Brin and co-founder Larry Page are both engineers, and they've been consistent in expressing a belief that form must always follow function. (Page has gone so far as to wonder why the home page needs anything except an empty search box.) That doesn't mean designers have to like it. Douglas Bowman, Google's first visual designer, left the company in March 2009–and lit the Web equivalent of a bonfire on his way out the door. In a post on stopdesign.com, Bowman claimed that at Google, data "becomes a crutch for every decision, paralyzing the company and preventing it from making any daring design decisions." He noted that one project was delayed when a team couldn't decide between two blues–so it tested 41 different



A "stand-up" meeting of the V8 design team in April

shades between them. "I had a recent debate over whether a border should be three, four, or five pixels wide, and was asked to prove my case," wrote Bowman, who is now the creative director at Twitter.

Other ex-Google design stars acknowledge that the emphasis on data can be grating. Jeffrey Veen, who joined Google as design director in 2006, says "the designers I worked with were fantastic but very formally trained in human computer interaction rather than having MFAs. That frames how design happens at Google." Veen, who left the company in 2008, adds: "None of the colleagues I would want to hire would be able to get a job at Google because of the computer-science-based requirements."

Mayer, the vice-president of search products, doesn't buy the criticism. "We're not curtailing instinct at all," she says. "We need that to fuel the innovation engine that yields great designs from Google. What we can do is use the power of the Internet and the measurability of it to figure out in a scientific way if something is a good idea or not." Wiley, V8's chief designer, insists he's comfortable with the mission and understands that search design is not intended to wow users. "It's like lighting design or sound design in a movie," he says. "If you're sitting watching a movie and you say, 'that's really great sound design!' then that's probably not right. ... I don't want someone to say 'look at this gorgeous search results page!' I want them to say 'where's my...?' And click, they've gone."

In the period leading up to the rollout, changes continued. Some were major: The launch date slipped five times. A plan to include a widget underneath the search query box so users could tailor results to their location was dropped after engineers decided the technology didn't perform consistently enough. A feature offering users a way to look for similar types of results was renamed from "Not Entirely Unlike" (an oblique homage to sci-fi author Douglas Adams) to the less whimsical, more intuitive "Something Different."

As the redesign was being unveiled to the world via a blog post penned by Mayer, the team continued working. For the engineers, launch is the most critical and nerve-racking time. "We'll definitely be biting our fingernails. You can't just turn this on with a switch," says Gaylinn. Even as the team breaks up and moves onto different projects, changes will continue. "In many ways the project never really completely ends," says Janakiram. "There are always improvements to be made." B

PHOTOGRAPH BY BRYCE DUFFY FOR BLOOMBERG BUSINESSWEEK

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With Bono on board, Roger McNamee's Elevation Partners was the first celebrity private equity firm. Five years in, the founders are struggling to prove their very different private equity model makes sense.
By Bryant Urstadt and Ari Levy

What Is Roger Mc



PHOTOGRAPH: FILMMAGIC/GETTY IMAGES

McNamee, aka Chubby Wombat, with guitarist G.E. Smith (left) at Bonnaroo last summer

NameeSmoking?

"I don't know how many of you have a day job," says Chubby Wombat, leaning into the microphone between songs. "But I do, and right now it sucks." Chubby Wombat is the lead singer of a Grateful Dead-style jam band called Moonalice. He has long gray hair and wears a Philadelphia Phillies baseball shirt with the number "Four 20" on the back. Tonight's venue is Slim's, a warehouse-style concert space in San Francisco's SoMa district, with brick walls and a black ceiling studded with spotlights. There are maybe 200 people in the crowd, mostly folks who look like they have a Volkswagen bus somewhere in their past, or possibly out in the parking lot.

Wombat, you might have guessed, is a stage name. In real life, this man is Roger McNamee, managing director of Elevation Partners, a private equity firm that manages a $1.9 billion fund. McNamee is a Silicon Valley legend who ran a successful tech fund for T. Rowe Price, invested in Intuit while at Integral Capital Partners, called the top of the dot-com bubble, and co-founded Silver Lake Partners, the highly successful tech-focused private equity firm.

As Chubby Wombat, McNamee is on a roll. Moonalice has served up 292,000 downloads of a catchy ditty called *It's 4:20 Somewhere*. It's a hummable tune about getting high—"4:20" is stoner code for smoking time—that has bucked the odds and found an audience. It's the breakthrough every artist dreams about, and tonight is particularly special for the song and the band. It's Apr. 20 ... 4/20. Tickets to the show are ... $4.20.

As good as life is for Chubby Wombat, Roger McNamee might have a few good reasons to complain about his day job. Like many of its peers in the private equity world, Elevation Partners, the firm he founded with a roster of Silicon Valley talent and a rock star named Bono, has been struggling. Elevation's largest position is in Palm, a $460 million bet that the once-dominant phone maker would not only survive but prosper with a hot new model. After Palm's chief executive officer, Jon Rubinstein, announced in late March that the company would miss already grim estimates, three analysts set a coroner's target price: $0. Palm was ultimately saved by Hewlett-Packard, which offered $1.2 billion for the company on Apr. 28, enabling Elevation to escape with a narrow profit well below its original expectations.

Elevation's other high-profile problem is a 40 percent stake in Forbes Media, which Elevation bought in August 2006. Although the company is private, and thus hard to value, Elevation's estimated $300 million stake in the magazine and its Web site is well underwater. McNamee's conviction that growth in online advertising would outstrip the decline in print revenue has not been borne out. Last year he stepped down from the board, with his partner Bret Pearlman taking his place. At Forbes, major cost-cutting initiatives have ensued.

Not surprisingly, certain indelicate elements of society (cough: blogs!) have been making a fine sport of McNamee, Wombat, Elevation, Bono, and Palm. In March a site called 24/7 Wall Street ran a story titled "Bono Becomes the Worst Investor in America." That sparked a flurry of mainstream coverage everywhere from *The Wall Street Journal* to the *Times of London* and a frenzied trade in plays on U2

lyrics, mostly along the lines of "Bono's Investment Firm Still Hasn't Found What It's Looking For" and "Palm Sale Is No Beautiful Day for Bono."

The West Coast office of Elevation Partners, where McNamee sat down for an interview the week before HP made its bid to take over Palm, is on Sand Hill Road, the Wall Street of Silicon Valley, a world away from Slim's. It's a place of quiet opulence, more like a spa than a financial office. You park in a little lot, under drooping trees and blooming shrubs, and proceed through a spacious lobby of pale pink marble with glass doors at the back that open onto still more gardens. There are photographs by Ansel Adams on the walls and a little sign that directs visitors to the right if they wish to visit the West Coast office of Kohlberg, Kravis & Roberts, and to the left for Elevation.

Out of his Wombat gear, McNamee still looks more like a professor of comparative musicology than a private equity baron. His hair hangs to his shoulders, and he wears a lavender shirt and a blue tie with pink bunnies. His playful appearance is quickly forgotten when he starts talking. In a nearly three-hour-long interview in the firm's conference room, McNamee and co-founder Fred Anderson, another Silicon Valley legend, give a rigorous, highly detailed picture of Elevation Partners and its dealmaking style.

"From the beginning, Elevation was a new approach to private equity," says McNamee. "The world did not need another high-leverage buyout fund. It didn't need another firm practicing venture investing in the traditional way."

McNamee is referring to a not-so-secret truth in Silicon Valley: Private equity and venture firms have been delivering low or negative returns for years, and certainly nothing like the 20 percent the sector has historically used to justify itself to investors. In focusing on deep involvement with a few operations, Elevation may also be bowing to reality, and following a trend. "What ended up happening is the private equity game got so much more competitive. Pure financial skills, crunching the numbers and structuring the deals became a commodity, so now firms are differentiating themselves through their operating skills," says Josh Lerner, a professor of investment banking at Harvard Business School. Nor is Lerner surprised by Elevation's duds. It's the missing win that is the problem. "It's always a skewed system of deal returns. You can have seven losers, but you have that one Google, that makes up for them."

It is safe to say that investors knew they would be getting something different with McNamee. He has been touring in various bands for years. His driver calls his Wi-Fi-enabled bus "the office." McNamee has no children and considers his band family, a statement that doesn't seem disingenuous when one learns that his wife, Ann, sings in the band.

Most of the firms that compete with Elevation spread their


Elevation's partners: Marc Bodnick, Bono, Roger McNamee, Bret Pearlman, and Fred Anderson

bets around, with each partner overseeing three to six deals. Elevation's idea was to distill the approach, finding the most talented people in the business and focusing big bets on a small number of companies. When McNamee and Elevation's co-founder, Marc Bodnick, started staffing the firm in 2004, one of McNamee's first calls was to Fred Anderson, who as Apple's chief financial officer during its financial crisis in 1999 helped the company stave off bankruptcy. Elevation's other partners include Pearlman, who came over from Blackstone Group, the giant New York buyout firm, and, of course, Bono. Bono, McNamee says, is very much involved in the fund: "He participates in all the investment activities, but he is magic with respect to internal partnership issues and opening doors."

In November and January, Elevation brought in two more Silicon Valley veterans, Rajiv Dutta and Avi Tevanian. As chief software technology officer at Apple, Tevanian oversaw the development of Mac OS X, the software behind everything from Macintosh computers to the iPhone and the iPad. "He's the greatest software architect of all time, period," says Anderson. Dutta is an eBay veteran as well as the former president of PayPal and Skype. The team, if nothing else, suggests that McNamee's night job as Chubby Wombat poses no threat to his credibility as a recruiter. The hiring of Dutta and Tevanian is also a signal that the firm wants to raise money for a new fund. But the Palm debacle has put whatever plans the firm had in that regard on hold.

"Our goal was to be two standard deviations off the mean, ideally to the right," says McNamee. By that he means to the right of the big bell curve of investing, where above-average returns show up.

PHOTOGRAPH: ART STREIBER/AUGUST IMAGE

"We thought [the Verizon launch] was going to be our coming-out party....

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... Everything was teed up that this was going to be the beginning of a huge ride."

Elevation will eke out a profit from Palm, thanks largely to Pearlman, the Blackstone vet who works in Elevation's New York office. If McNamee is almost comically West Coast, Pearlman, with his crisp white shirt and Bit loafers, is cut from central casting, too. In an interview in the company's Midtown office, a Zen-like retreat set in a skyscraper, Pearlman explains how he set up the firm's investment. If the other partners are visionaries, he is the worrier who thinks about how things will go wrong. "If you asked everyone at the firm who the most skeptical partner was," says Pearlman, "I'm sure I would fit the description."

Of the $460 million Elevation has put into Palm, only a fraction of it is in common shares. The initial $325 million investment was in convertible preferred shares at $8.50 a share. The remaining $135 million that Elevation invested was in a combination of convertible preferreds, warrants, and common shares. With HP offering $5.70 a share, one can do the math and arrive at an investment valuation for Elevation of $485 million, or about 5 percent over its total outlay.

That, however, is nowhere near Elevation's original lofty vision. McNamee and Anderson argue that Palm built a better phone based on an innovative Web-based operating system–and phone geeks seem to agree–but they picked the wrong carrier, Sprint, which soon headed into crisis mode itself.

Even amid sluggish sales at Sprint, Palm's stock rallied last year as excitement built around an expected partnership with Verizon, a deal Palm CEO Rubinstein finally announced at the Consumer Electronics Show in January. Later that month the Pre and Pixi phones debuted on Verizon, and the launch was a disaster. The carrier was unprepared or unwilling to put its marketing dollars and sales force behind the Pre, focusing instead on its own new brand, the Droid, featuring devices powered by Google's Android operating system.

On Palm's quarterly conference call in March, Rubinstein told investors that the training of Verizon sales staff had been inadequate. He said the problem was being remedied with aggressive training efforts at hundreds of stores nationwide a day. But the market had spoken. The stock had lost three-quarters of its value in six months.

"We thought [the Verizon launch] was going to be our coming-out party," says McNamee. "Everything was teed up that this was going to be the beginning of a huge ride."

Even as the company whiffed on its projections, Pearlman's structure saved Elevation's investment. The firm's other deals have similar backstopping. The Forbes position is known to have a put option embedded, meaning it can be sold back to the family at a preset price, though Elevation won't reveal the price or exactly how it works.

"We did not make a minority investment without a plan to exit," says Pearlman. "While we have a long time horizon, if we are going to make an investment with a family, we are going to, at some point, make sure that we have an ability to realize some liquidity."

The fund's $100 million investment in Move.com, the real estate listings site that has staggered along with the housing crisis, is also in convertible preferred shares, which pay an annual dividend of 3.5 percent.

As troubled as these recent deals have been, Elevation's early success has given the firm some margin for error. In 2005, Elevation invested $300 million in video game makers BioWare and Pandemic Studios, a stake it sold three years later to Electronic Arts for $620 million. And the firm has made two well-regarded investments, through back channels, purchasing a $100 million stake in the user-review site Yelp! and $90 million worth of shares in Facebook. Elevation hasn't discussed its involvement with Facebook, but, based on more recent transactions, its investment looks to have doubled.

The firm has deep ties to both companies and acts as much like a partner as an investor. McNamee has advised Facebook CEO Mark Zuckerberg since shortly after he came to Silicon Valley with a business model born in a college dorm room. As Chubby Wombat, he uses Facebook to advertise his gigs and serve up downloads of his song.

Similarly, Elevation was in touch with Yelp two years before making an investment, when partner Marc Bodnick met with Yelp's founders to offer advice. "They certainly offer as much as you want," says Yelp CEO and co-founder Jeremy Stoppelman, talking about Elevation's team. "They have a very senior, strong team with deep knowledge in company building. To the extent you ever have a need, they're there." When some employees wanted to cash out, Stoppelman allowed Elevation to buy in.

In McNamee's view, the close relationships with these companies are the key to Elevation's future, boosting the value of the first partnership in its final years and providing the starting point for the second, if it gets funded.

Halfway through the first fund's 10-year life, Elevation is at a juncture that will test the validity of its model, or at least whether partners will be willing to hang in for the next one.

"While there are no guarantees," says McNamee, "our returns are much better than people realize. But we live in a world of the blog, where it's shoot first, ask questions later."

Later that night, on stage, Chubby Wombat announces that Moonalice's hit song is near 300,000 downloads. "When we get to 420,000 downloads," he says, "we're going to give ourselves an award." He also notes that the band has brought 420 cupcakes to celebrate. Then the group launches into a blues number that includes a goofy jab at leveraged buyout firms. ("They put you out of work, but it makes your stock worth more.") All silliness aside, it's a surprisingly decent tune. McNamee is a good singer, and he has hired a skilled, professional band, including a guy who played bass for Jefferson Airplane. In the end, leading a firm like Elevation is like leading a band. You get talented people together, work hard, and hope for a hit. B



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How Much Is A CEO Worth?

By Jessica Silver-Greenberg and Alexis Leondis

Kenneth Feinberg, the U.S. Treasury Dept.'s pay czar, recently reduced executive salaries at government-controlled American International Group and General Motors to reflect company performance. In much of Corporate America, as *Bloomberg Businessweek* first reported in its Apr. 5 issue, no such realignment took place.

Graef Crystal, a pioneer in compensation consulting, analyzed the 2009 pay of 271 chief executive officers. His findings? "Simply put," Crystal says, "companies don't pay for performance."

Although there is no standard method for analyzing compensation, Crystal, 76, developed the formulas he uses over the course of 30 years advising companies such as CBS, Coca-Cola, and American Express on their pay practices. In an ideal world, Crystal and many investors agree, stock performance and CEO pay would be closely aligned. But no matter how he parsed the numbers, Crystal discovered no relationship between shareholder returns and CEO compensation.

At the outset, he found that the CEOs' average pay went down 4.7 percent last year to $9.95 million. The highest paid was CBS's Leslie Moonves with $43.2 million, and the lowest was Citigroup's Vikram Pandit with $128,751. Crystal didn't include any bonuses awarded in 2010 in his analysis.

Crystal then created a "fair pay" model that redistributed the $2.7 billion aggregate payroll of all of the CEOs according to each company's shareholder return, adjusted for company size. Under that model, Moonves would have taken a $28 million pay cut, while Google's Eric Schmidt, who was the second-lowest paid last year with $245,322, would have seen an increase to $17.4 million. Frank Baldino Jr., the founder of Cephalon, was the most overpaid, according to Crystal's algorithm: He took home $11.15 million, eight times more than what the model said he deserved.

Crystal recommends awarding stock options with a strike price that's the average of the last 90 days and can't be exercised for five years to avoid "opportunistic" pricing. He also suggests reducing bonuses if incentive targets aren't met.

Some of Crystal's former clients have called him a Judas for criticizing the system he used to be a part of. He prefers to be compared to Mary Magdalene. "Maybe I was a hooker," he says. "But I'm hoping to end my life as a saint." B

THE 10 EXECUTIVES PAID THE MOST

01. Leslie Moonves *CBS*	$43,238,875
02. Philippe Dauman *Viacom*	$34,009,990
03. Ray Irani *Occidental Petroleum*	$31, 401, 356
04. William Weldon *Johnson & Johnson*	$30,813,844
05. Thomas Ryan *CVS Caremark*	$30,429,113
06. Glen Senk *Urban Outfitters*	$29,944,180
07. Randall Stephenson *AT&T*	$29,230,506
08. James Hackett *Anadarko Petroleum*	$27,466,777
09. Brian Roberts *Comcast*	$27,246,367
10. Rex W. Tillerson *ExxonMobil*	$27,168,317

THE 10 EXECUTIVES PAID THE LEAST

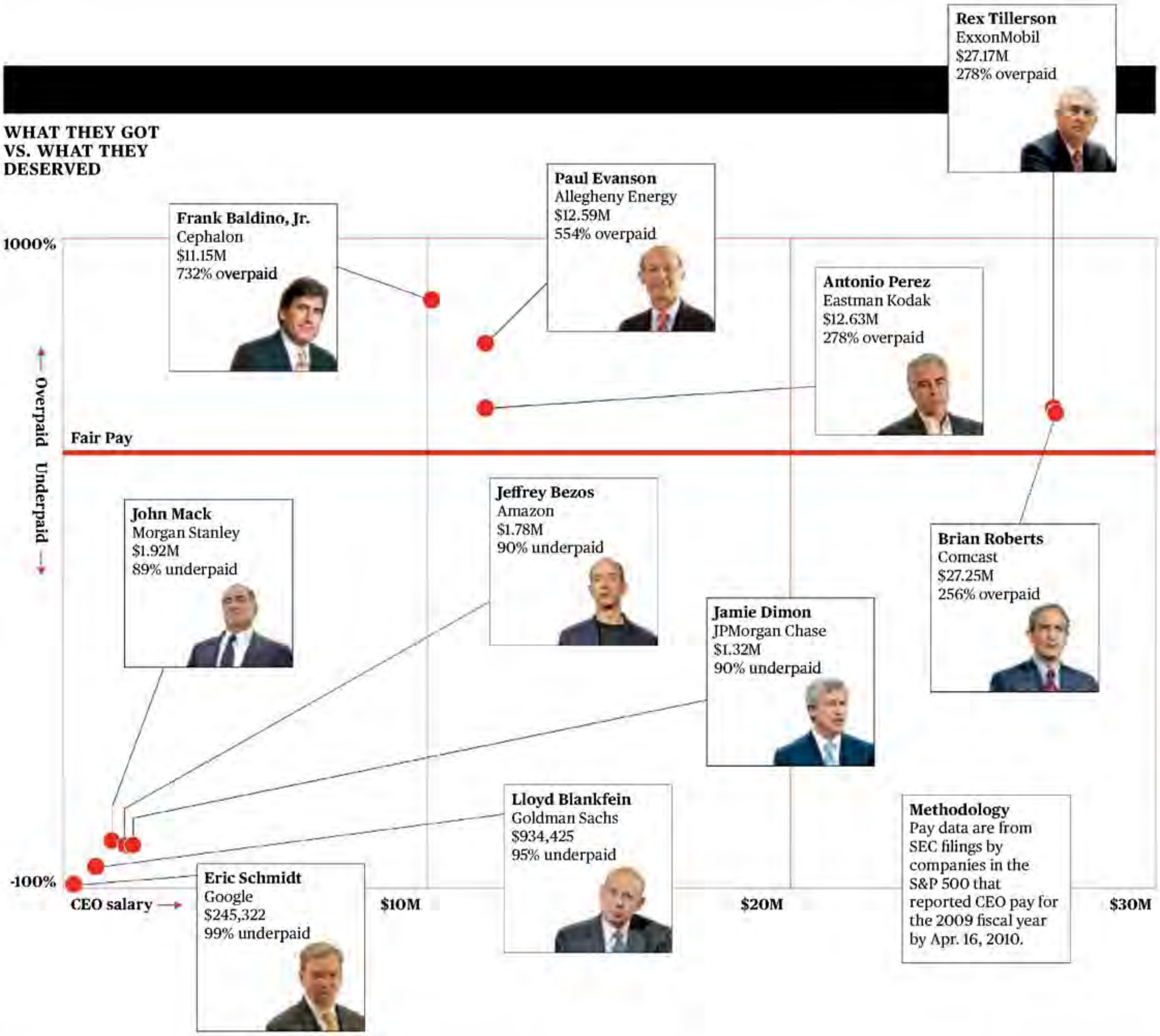
01. Vikram Pandit *Citigroup*	$128,751
02. Eric Schmidt *Google*	$245,322
03. Donald Graham *The Washington Post*	$472,997
04. Lloyd Blankfein *Goldman Sachs*	$934,425
05. Willard Oberton *Fastenal*	$945,092
06. Douglas Berthiaume *Waters Corp.*	$1,010,393
07. Ian Cumming *Leucadia National*	$1,011,850
08. Jamie Dimon *JPMorgan Chase*	$1,322,094
09. Harris Simmons *Zions Bancorp.*	$1,373,352
10. Gary Kelly *Southwest Airlines*	$1,559,431

Blankfein did get $9 million in stock, awarded in 2010

For a complete list, go to www.bloomberg.com/insight/ceopay.html

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WHAT THEY GOT VS. WHAT THEY DESERVED



Methodology
Pay data are from SEC filings by companies in the S&P 500 that reported CEO pay for the 2009 fiscal year by Apr. 16, 2010.

WHAT THEY MADE VS. SHAREHOLDERS



Overpaid CEOs		Shareholder Return
Frank Baldino Jr.	Cephalon	-19.0%
Paul Evanson	Allegheny Energy	-28.9%
Antonio Perez	Eastman Kodak	-35.9%
Brian Roberts	Comcast	1.7%
Rex Tillerson	ExxonMobil	-12.6%



Underpaid CEOs		Shareholder Return
John Mack	Morgan Stanley	87.9%
Jeffrey Bezos	Amazon	162.3%
Jamie Dimon	JPMorgan Chase	34.4%
Lloyd Blankfein	Goldman Sachs	102.5%
Eric Schmidt	Google	101.5%

Methodology
The "fair pay" model redistributes $2.7 billion in aggregate CEO pay using a formula based two-thirds on stock performance and one-third on company revenues.

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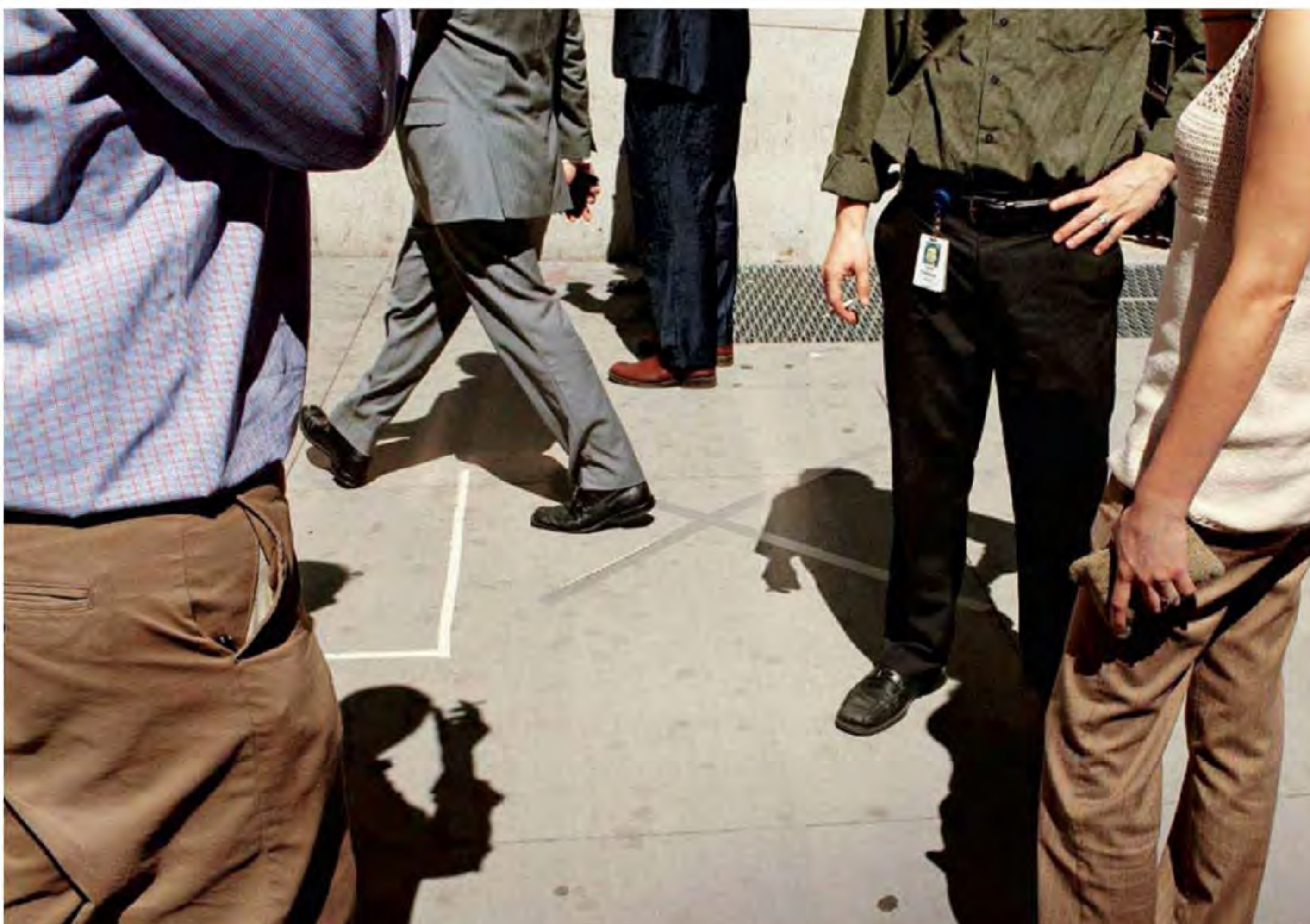
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Etc.

Take a look inside investor Stephanie Pomboy's recession-proof portfolio Page 80





The Secret Cult of Office Smokers

Ostracized by their peers, smokers are taking advantage of their time together *By Joel Stein*

Photograph by Jeff Mermelstein

GOLD: GETTY IMAGES

Etc. Smoking

I have never taken even one puff of a cigarette, which is how I've always known that smoking is cool. However, my faith in that assumption is weakened every time I walk by an office building. All those people shivering outside in their little smoking leper colony replaces the James Dean-era image of motorcycle freedom with one of Henry Ford-era dirty workers taking their elevenses with bourbon from the factory store.

Not so long ago a cigarette was a way of showing how dedicated you were to your job, like eating lunch at your desk or chugging a Red Bull during an all-nighter. During World War I, cigarettes came with a soldier's field rations. FDR dangled one while war planning with Churchill and Stalin. Picasso took drags while painting. Keith Hernandez lit up right in the dugout while waiting for his at-bat. (That's right: People smoked at work even if their job was exercising.) Now that only an estimated 20.6 percent of Americans smoke—a 3.5 percent decline over the previous decade—the nonsmoking majority has kicked them out of not only hotels and restaurants but even the one place they have to be. And while white-collar workers smoke much less than everyone else—only 14.6 percent in 2007, compared with 28 percent of blue-collar workers—their offices are much more likely to ban smoking (81.9 percent in 2007) than blue-collar workplaces (62.1 percent that same year).

Smoking has been banished and ostracized from nearly every workplace in America, with laws in many cities forcing smokers to stand 20 feet from any building entrance. In some giant companies, they're kicked off the entire campus, which means a sad, slow walk down to the highway. Last year at the Manhattan office of Hudson Yards, a digital imaging and photo retouching company, President Diane Romano started forcing smokers to punch out during their breaks. The policy change, along with a hypnotist she hired, have reduced her smoking employees from 11 to 3. "I'm not paying you to smoke. I'm paying you to work," says Romano, who figured each break took about 15 minutes, including the time to get down to the sidewalk from the company's 11th-floor office in the elevator. "If it's one or two cigarettes a day, O.K., but when people are going out five times a day, they're losing at least an hour. That's three full workdays every month. It's not fair for those who don't smoke."

All the evidence led me to the conclusion that the coolness of smoking during work was over. I was way wrong. What I hadn't understood was that smokers are precisely the type of people who thrive on being ostracized and banished. These aren't the ex-football players and class presidents who fought for your approval. These are the brooding loners, the ones who—according to the teen smoking analysis found in Malcolm Gladwell's *The Tipping Point*—start smoking not because they want to look cool but because it goes along with

20.6%
Estimated percentage of Americans who smoke, down 3.5% in a decade

81.9%
Percentage of U.S. office buildings with white-collar workers that ban smoking

DATA: CENTERS FOR DISEASE CONTROL

An Office Suitable for Smoking



It's "smoke 'em if you got 'em" at Philip Morris

If *Mad Men*'s Don Draper were working today—and still maintaining his considerable nicotine habit—he might want to leave New York City, where smoking in workplaces has been banned since 2003, for Virginia. At the Richmond headquarters of Philip Morris USA, smoking in one's office is acceptable. "Employees who have an office and can close their door are allowed to smoke in them," says Bill Phelps, a spokesman for Altria, the parent company of Philip Morris, which controlled 50.7 percent of the U.S. cigarette market as of 2008. What's more, Draper might even save money. Each Philip Morris employee is allowed either one pack of cigarettes or one tin of dip per day for free. An employee need only swipe his or her badge in one of the company's vending machines.

According to Phelps, cubicle-bound employees can take their cigarette breaks in designated rooms, while nonsmokers on staff can take a breather in specified smoke-free areas. Those wishing to kick the habit can take advantage of the QuitAssist program, which is featured prominently on Philip Morris' Web site. The program links to a menu of methods and resources. Among them is a tip sheet from the Centers for Disease Control that advises employees to "get rid of all cigarettes and ashtrays in your home, car, and place of work." It also urges them not to smoke after successfully quitting—"not even a *puff*!" (emphasis theirs). Altria doesn't keep a record of which of its employees smoke and declined to comment on whether insurance companies charge its employees higher premiums. —*Julian Sancton*

ILLUSTRATION BY TED MCGRATH

all their other self-destructive, class-cutting, early-sex, authority-flouting coolness. These are people who willingly put fire in their mouths. So that little area in front of the building that looks so lame from afar is actually the high school bathroom of the Information Age. Around the country all the cool engineers, accountants, and salespeople skip out of work, duck their boss, gather outside the building, gossip, and—though I could not confirm this—make fun of me.

I also discovered smoking was still cool because none of the people whom I talked to were willing to give me both their name and the company they work for on the record. That only happens when you write about the CIA, extramarital affairs, or AIG. In their anonymity, numerous smokers told me that, while the nonsmokers look down on them as slackers, their habits have actually helped advance their careers. A salesman for online ads says he has a special bond with clients who smoke, and Jennifer, who worked at an accounting consulting firm in Orange County, Calif., claims that—just like in episodes of *Friends* and *How I Met Your Mother*—she never did better at work than when she had a boss who smoked. "That's how I got to know her well, outside during breaks. I'd score some brownie points and she put me in charge of a job in my first year," she said.

While Jennifer, who has held several jobs, never lets anyone know that she smokes during the interview process—"You want to make a good impression," she explains—she still sniffs out her smoking co-workers on her first day. "You say, 'Oh my God, I need a cigarette' after something stressful, and they say, 'Oh, so-and-so smokes.' So you ask so-and-so if they want to smoke. It's like an excuse to meet someone new. You make a lot more friends like that." Friends, I'm guessing, who are a lot more fun than when I try to meet people at a new job by saying, "Man, that was stressful. Almost like when I was deciding whether to play Luis Valbuena or Mike Aviles as backup shortstop in my fantasy team."

Wanting to see how these nicotine hipster societies make do with their decidedly un-Parisian café surroundings, I stood outside a building that houses a large online marketing company in Los Angeles employing about 150 people—I have already said too much—where I met 3 of the office's 10 smokers who had gathered a short distance from the building's entrance. They used to smoke in a little outdoor hallway that shielded them from their supevisor's exits and entrances, until workers at some other company with a door near their hiding place complained about the smoke. They've also been banished by the office management from the sides and back of the building, sequestered in this tiny area with a few metal tables and benches.

Ben Rich, a salesman, takes a drag and complains about how his co-workers view his habit. "You're the jerk who's smoking, taking breaks," he says. "If you smoke, they make assumptions about your lifestyle." When I ask him what kinds of assumptions, he looks down: "That I'm never home. That I'm overly social." I had never before considered the emotional struggles of the cool.



BOB MILLER/LENSMODERN

Corporate smokers refuse to offer their names. It's as if they work for the CIA—or AIG

Rich was summoned to this particular smoke break by an instant message from software engineer Sooraj Akkammadam, who says his co-workers make a big deal over the three to five trips a day he takes outside. "One guy acts like it's poison gas when we come back," Akkammadam says. And while some co-workers resent them for taking breaks, most of them—argues fellow smoker and



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Etc. Smoking

engineer Yevegni Tovbin–take longer trips to buy Frappuccinos. Plus, it's difficult for their boss to complain, since he has installed both an arcade machine and a Ping-Pong table in the office. Besides, Akkammadam thinks that smoking breaks allow him to meet people who aren't on his team, that they encourage cross-departmental collaboration that wouldn't otherwise occur, and give him time to brainstorm work ideas. Smoking, the way Akkammadam sees it, is a lot like a really cheap off-site meeting.

After the three finish their cigarettes and are about to head back up, another engineer with a habit, Paul Lee, walks outside. He's not surprised to see his smoking buddies. "I've worked at lots of places in a lot of cities and there is some kind of timing where people go out at a very certain time," Lee says. Raised to be a gentleman in Alabama, Lee refuses to light up around a female nonsmoking co-worker and waits until she walks away before smoking. When Lee heads down to the metal tables, Akkammadam, who was about to go back into the building, pulls out his pack, taps another cigarette, and follows him. "I can't leave this guy hanging," he explains. Then he walked away and left me hanging.

Even at *The Onion* newspaper, where the job is to rebel against authority, the staffers have to wait for the slow, old elevator to take them 10 floors down to Broadway in New York's SoHo. "It is a little bit humiliating. It makes you realize that you're not some urban sophisticate smoking. You're more like a dumb animal outside the building smoking," says *Onion* Senior Editor Todd Hanson.

Still, the current situation seems better than when he worked for the humor paper in its old headquarters in Madison, Wis., where Hanson put his desk inside a stairwell so he could smoke–until the fire department kicked his desk out. So he worked in the stairwell deskless, writing longhand. All these obstacles have only deepened his dedication to smoking breaks and brought him closer to his fellow addicts. "Among the few holdouts who haven't died of lung cancer yet, the camaraderie is stronger," he says. That's because what doesn't kill them only serves to make them cooler.

Have we lost too much and gained too little by kicking the smokers out onto the curb? At each office, out there far from where we can hear them, they've formed a little supergroup of cool, brave, overly social workers who help one another climb the corporate ladder. If you doubt this, consider that a smoker who was just a first-term senator a few years ago is now the President of the United States. If John Edwards had been a smoker, he might have met far more useful people than Reille Hunter. Ⓑ

46 million
The approximate number of American adults who smoked cigarettes in 2008

371 million
The estimated number of cigarettes consumed in the U.S. in 2006

DATA: CENTERS FOR DISEASE CONTROL

"You're more like a dumb animal outside the building," says an editor at *The Onion* of his habit

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A Well-Designed Leap of Faith

Getting her baubles into *Vogue* helped Golden create demand among store buyers and consumers



In the middle of a recession, Jill Golden left a glam job at Lancôme to launch a jewelry line

As a nine-year-old in Michigan, Jill Golden sold beaded safety-pin bracelets to a local tween store. Her childhood passion led her into the luxury goods business, with stints at Cartier and David Yurman. In 2003, she landed what seemed like a dream job in the beauty industry, as an assistant vice-president at Lancôme, buying advertising and negotiating partnerships.

Golden never stopped designing, and in 2004, while on a jury duty lunchbreak, she registered a tax ID number for a jewelry company called Flutter NYC. (The name comes from her love of travel, which she calls "fluttering.") Three years later she launched www.flutternyc.com and her business began growing through word of mouth. When Lancôme offered her a lateral move in 2008, Golden, now 38, decided it was time to leave corporate life and turn her childhood fascination into a career. "It was the perfect time," she says. "It was a calculated risk, but still a risk."

Golden lessened the risk with shrewd publicity. On the advice of a magazine publisher she hired a PR firm that had strong relationships with jewelry editors. Getting their blessing proved a smart move in a recession: Her jewelry has since appeared in fashion bibles *Vogue, Harper's Bazaar,* and *Elle,* which "gave store buyers and consumers confidence," she says. Golden sees her customer as a stylish, independent woman "not driven by one designer or celebrity." Her pieces, made of materials ranging from oxidized brass to vintage German stones and carnelian, sell for as much as $600 at high-end boutiques including Harvey Nichols in Dubai.

The one-bedroom Manhattan apartment that doubles as her work space (after $8,000 in remodeling) is leagues away from Lancôme's sleek offices, yet Golden measures her biggest transition not in square feet but in inches: from the four-inch stilettos she used to don at Lancome to the 1/2-inch flats she wears now. Within the next year she aims to lease a studio space and hire her first employees. "I loved the industry but the corporate politics got me down," she says. "I'm a lot happier now." Ⓑ *—Joan Caplin*

A brooch with Swarovski crystals ($368) from Golden's collection



FROM MAKING MEDIA BUYS TO MAKING JEWELRY

Weekly work hours at Lancôme vs. Flutter NYC: 50 (plus two to four evening events) vs. 105 hours at Flutter

Rise in health care costs: From $1,188 at Lancôme to $5,820 at Flutter NYC

Cost of creating www.flutternyc.com: $10,000

Cost of printed materials (look books, mailers): $14,500 per year

Pieces of Flutter NYC jewelry made in April 2010: 1,500

Retail stores buying Flutter NYC jewelry in April 2010: 40

Price range of the jewelry: $95 (an oxidized brass ring) to $600 (a necklace with blue-green chalcedony stones)

Cost of leather and vintage brass to start making Spring 2011 line: $4,000 and $780, respectively

Membership cost to join Soho House, used for business meetings: $1,800

Number of employees: 0

TOP: PHOTOGRAPH BY DAVID YELLEN FOR BLOOMBERG BUSINESSWEEK

Etc. Discerning Tastes



Hotelier **Alex Calderwood's** personal guide to the perfect travel experience

Favorite city: Paris. Amsterdam is a close second. The Dylan hotel there is fantastic.
Favorite hotel: The St. Cecilia in Austin–the rooms, the public spaces, the attention to detail.
Favorite motel: The Beverly Laurel Motor Hotel in LA. *Swingers* was filmed there.
Best hotel bar: The Hotel Costes in Paris.
Vital hotel amenity: Good room service.
Indispensable feature: You can have a beautiful room, but if the bed's bad, it sucks.
Must-have in-room toy: Music Hall Audio turntables are great.
Lobby music secret: John Richards, who deejays for Seattle indie station KEXP and lives in New York.
How to test the concierge: I trust him if he mentions anything that I've read about on superfuture.com or tabletguides.com. If his recommendations sound middle of the road, I ask where the staff hangs out.
Upgrade tip: Go as late in the evening as possible and ask if you can [move up] to the next room category. If the hotel is not full, $50 can take you from a double to a suite.
Best turn-down treatment: About 10 years ago I stayed somewhere in the Northwest where they put very large vitamin C tablets on the bed.
Travel accessory reminiscent of home: I bought a macramé owl at a flea market that I wanted to put in our Palm Springs hotel.
Room service meal: Eggs Benedict on a Sunday morning with *The New York Times*
Bedside Bible: We stock our bedside tables with the *Kama Sutra* and tiny pocket Bibles made for the U.S. Army that are covered in camouflage.
Packing strategy: The same Supreme duffle bag has brought me around the globe for at least 10 years. And I always pack only one color of socks since I'm bound to lose one along the way.
Quintessential hotel movie scene: In the original *Pink Panther,* Peter Sellers stayed in a ski chalet that I always thought was out of this world; Royal Tenenbaum working in a hotel was pretty memorable; and the scenes in the Polo Lounge [at the Beverly Hills Hotel] from *American Gigolo*.
Reason for no toothpaste in hotel bathrooms: It never occurred to me. I'll consider it! For the time being, if you ask for a tube, we'll send one up. Ⓑ
—Interview by Claire Howorth



Since opening his first Ace Hotel in 1999 in his native Seattle, co-owner Alex Calderwood, 39, has redefined the boutique hotel experience with locations in New York, Palm Springs, Calif., and Portland, Ore.,

CALDERWOOD: DOUGLAS LYLE THOMPSON; EGGS: STOCKFOOD; ST. CECILIA: ALLISON V. SMITH; RICHARDS: DORON GILD; SELLERS: EVERETT; CASH: CORBIS; EIFFEL TOWER, VITAMIN: ALAMY (2)

Etc. Wealth



Where to Be When The 'Sugar High' Fades

Portfolio provocateur Stephanie Pomboy of MacroMavens on why she's feeling so bearish

Every few months, I host a dinner party in New York with my favorite analyst and money manager clients. They tend to be fairly skeptical about the stock market. Someone will break out gold coins and say he's a big owner. Others will talk about their gun of choice in case the economy collapses. It can get very dark, but at a recent dinner, guests were much more optimistic. Some were saying that profits look great and that U.S. stocks should do well after we've already rallied 75 percent. So it appears the grizzlies have capitulated.

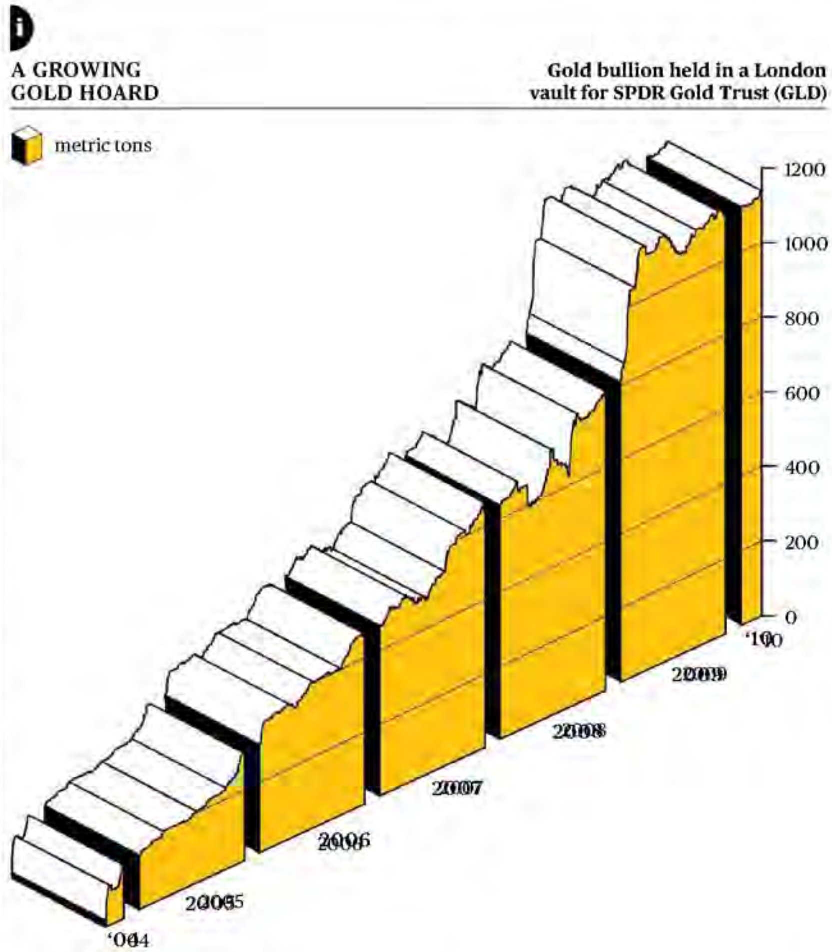
The U.S. is in the throes of a secular shift in consumer behavior, and consumers will retrench. The effects of the housing bubble bust will linger. People want to believe the good news, but they shouldn't let themselves be fooled by the continued growth in consumer spending.

I see some short-term explanations for why it's up. One, unemployment insurance benefits have substituted for wage income. Two, for high-end consumers, tax refunds are a major story—they're running about 10% ahead of last year. This goes a long way toward explaining strength in things like iPad sales. A third factor is largely unquantifiable, not to mention cynical. People have stopped paying mortgages, and banks have been so slow to kick people out of homes. If you're saving $1,000 a month by not paying your mortgage, why not buy an iPad or take a vacation?

Looking at the end of the tax refund season—with unemployment benefits extensions petering out for some, the end of the Federal Reserve's support of the mortgage market, and the home buyers' tax credit expiring—it feels like a perfect storm is brewing at a time when the market has become almost frothy again. When the sugar high wears off, we're going to have a renewed decline in home prices that will lead to a new round of credit hits. It will shock many that we're not back to 2007's strong economy.

I'm keeping my powder dry. I'm long Treasuries because I think there will be a moment when people realize the economy isn't as strong as they think. At the same time, there will be a flight back to safety. Both forces should benefit Treasuries. I'm also bullish on oil and gold because emerging economies will want those resources. I have more than 50% of my portfolio in cash and gold. I have physical gold, money in the SPDR Gold Trust [an exchange-traded fund], and gold mining stocks. I don't view gold as being in a bubble. To me, gold is a currency—my protection against further debasement of the dollar.

As for stocks, I would overweight U.S. multinationals that sell things everybody around the world is going to want to buy, like Procter & Gamble. I would avoid high-end-retail stocks. I personally have a short position in the Nasdaq 100 index, and I would never recommend that for individual investors. They are better off waiting to figure out where the growth opportunities are. *—As told to Lewis Braham*



DATA: WORLD GOLD COUNCIL; STATE STREET GLOBAL ADVISORS

I'm keeping my powder dry. I'm long Treasuries.... There will be a flight back to safety

The Stats: Stephanie Pomboy is founder and president of financial research firm MacroMavens, which serves institutional investors, including global hedge funds and some of the largest U.S. mutual funds. She worked with economist Ed Hyman at ISI group for 11 years before starting MacroMavens in 2002.

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Surveillance for Dummies

Avaak offers Big Brother technology in a small size

By Rich Jaroslovsky

If there is a simpler way to monitor the goings-on in your home than with Avaak's Vue Personal Network, I have yet to discover it. The Vue is an Internet-connected video system that enables you to spy, er, watch feeds and remotely control up to 50 unobtrusive wireless cameras via the Web or a new, free iPhone application. (Versions for BlackBerry and Android smartphones are in the works.) It isn't a full-scale surveillance system, but it's perfect for checking up on just about anything.

The basic Vue system ($299, VueZone.com) consists of two cameras–each about the size of the circle made by your thumb and index finger in the universal O.K. sign–and a compact antenna-like device called a gateway. The kit comes with swivel mounts; extra cameras are $99 each.

Unlike Wi-Fi systems, the Vue creates its own network between the gateway and cameras, like cordless telephones communicating with a base station. Setup is foolproof: Plug the gateway into an Ethernet port on your router, and pair it with the cameras by placing them nearby and pressing a button.

Each camera weighs less than an ounce and runs on a standard lithium-ion photo battery, which lasts about a year under normal use. There's no software; everything is controlled via the Internet, whether you're next door or half a world away.

I aimed one camera at our poodle's cage in hopes of answering the age-old question: What does she do when she's alone? The answer: She spends a surprisingly long time sitting alertly in a show-dog pose before finally curling up for a nap.

While the Vue is terrific when the task at hand is a little casual snooping, it's less useful for mission-critical jobs. The picture quality is merely adequate, and motion tends to be herky-jerky. From a PC, the system occasionally gave me a message that a camera, probably because of Internet congestion, was offline. Even in a location with a strong Wi-Fi presence, the iPhone app would sometimes present me with a message that the signal was too weak to use. (Things were fine when I switched to the phone's 3G connection.)

From either the site or the iPhone app, you can view live feeds, take a photo, and adjust the brightness. Video recordings are saved on the VueZone site, where they can be played, uploaded, or e-mailed. Two gigabytes of storage are free the first year, $19.95 thereafter, and you can also authorize friends to tap into your live feed. It's up to you, however, to give them something worth watching. B

i OTHER PRYING PREFERENCES



Panasonic BL-C230A Network Camera

(Panasonic USA, $299.95) Wireless with remote panning



WiLife Digital Video Security Master Camera

(Logitech, $299.99) Alerts user with e-mail



HomeRemote Pro Gateway and Camera

(Hawking Technologies, $299.25) Can work with door sensors

TOP: PHOTOGRAPH BY TOM SCHIERLITZ FOR BLOOMBERG BUSINESSWEEK

Etc. A Free Day In...

Singapore

Where to find a taste of the old city-state, from Malay stalls to old-fashioned confectioneries

Since the 1960s, when the once-sleepy colonial city-state began an aggressive modernization program, Singapore has shucked off most of its past. Not of all it, though. Beneath the shiny contemporary veneer, distinctive pockets of what once was remains.

To find them, start with a hearty native breakfast at Adam Road Food Centre, an open-air food court packed with tiny stalls that serve Malay and Indian delicacies. At Selera Rasa Nasi Lemak, coconut-infused rice with crispy anchovies, fried chicken wings, spicy chili sauce, and egg has been drawing locals for years.

For lighter fare, venture to an authentic *kopitiam*, or old-style coffee shop, at the small, 1950s-style Chin Mee Chin Confectionery. Try the toast topped with butter and house-made *kaya*—a local coconut jam—paired with a cup of the "Yin-Yang," a combination of coffee and tea.

Not far from the financial district, the Singapore Art Museum, housed in a beautiful colonial structure dating back to the mid-19th century, often features exhibitions showcasing Southeast Asian artists. From there, walk five minutes to the Mint Museum of Toys (Enthusiasts, take note: "Mint" stands for "Moment of Imagination and Nostalgia with Toys") located along a narrow street right next to Raffles Hotel. A short cab ride away, in the city's Kampong Glam neighborhood, near the golden-domed Sultan Mosque, myriad Malay coffee shops serve piping hot *teh halia*, the traditional milky ginger tea.

Changi Village, a sleepy, seaside neighborhood on the East Coast, is a place to visit a *kelong*. These fishing platforms, built on wooden stilts out in the Serangoon Harbour, are a dying breed in the city. (In the 1950s there were about 300 in Singapore; fewer than 20 remain.) To get to a *kelong*, first make a pit stop at Charlie's Corner, a mom-and-pop outdoor watering hole that serves an impressive selection of beers. Then clamber into a little bumboat for a 10-minute chug out to Changi Fishery, where you can enjoy an al fresco seafood dinner surrounded by paper lanterns and water. "This," says co-owner Rosemary Lau, "is how Singapore was 50 years ago." B —*Cheryl Lu-Lien Tan*



The Singapore Art Museum



A *kelong*



A tale of two cities

GUIDE: SINGAPORE



1. Selera Rasa Nasi Lemak, Adam Road Food Centre, 2 Adam Rd., Stall 2. This small Malay food stall sells coconut rice with crispy anchovies, egg, and fried chicken wings for less than $4—a popular breakfast with locals.

2. Changi Fishery (+65 9615-0215) Call at least three days ahead to arrange your *kelong* dinner.

3. Singapore Art Museum (+65 6332-3222) 71 Bras Basah Rd. Housed in a colonial building, it showcases art from Singapore and Southeast Asia. Check out the current exhibit, "Realism in Asian Art."

4. Mint Museum of Toys (+65 6339-0660) 26 Seah St. Located on a narrow lane right by the historic Raffles Hotel, Mint houses a collection of toys that date back 100 years. Its rooftop bar is a perfect place for a sunset cocktail.

5. Sultan Mosque (+65 6293-4405) 3 Muscat St. One of Singapore's oldest places of worship, the mosque still draws Muslims from all over the region.

6. Chin Mee Chin Confectionery (+65 6345-0419) 204 East Coast Rd. The old-school coffeeshop ambience at this 1950s throwback isn't the only draw. Try the homemade *kaya* (a Singaporean coconut jam) on hot buttered rolls.

CLOCKWISE FROM TOP LEFT: THEODORE WATSON AND EMILY GOBEILLE/SINGAPORE ART MUSEUM; PETER BIALOBRZESKI/LAIF/REDUX; SINGAPORE TOURISM BOARD

Etc. One True Thing

The Bag



A British beauty that can handle everything you throw in it

The Want: The perfect bag should be sophisticated and versatile; a mobile office that can also carry gym clothes without looking like a gym bag. Think high-end furniture, not splashy fashion statement. Messenger bags—or anything made from alligator skin—need not apply. Also: must fit the overhead compartment.

The Get: Burberry's Tarnished Leather Weekend Bag ($1,295 at uk.burberry.com). Handsome and elegantly crafted, with plenty of room for a laptop and a change of clothes. It has the added benefit of being water-resistant, something you might not expect from a bag that looks this good. **B** —*Tony Gervino*

A BAG FOR EVERY PERSONALITY



The Prep

The Billy Kirk No 165 Medium Carryall ($320: billykirk.com) is light enough to tote from the club to the course



The Klutz

The Samsonite Xenon Shock Absorber Briefcase ($54: samsonite.com) has foam paneling that protects laptops



The Outdoorsman

Army-green nylon and leather gives Filson's Passage Saddlebag Briefcase ($220: filson.com) an adventurous edge



The Frequent Flier

Victorianox's First-Class Computer Brief ($350: swissarmy.com) has a removable laptop sleeve



The Workaholic

The Tumi Alpha Expandable Organizer Computer Brief ($550: tumi.com) can handle the heaviest office load

LEFT: PHOTOGRAPH BY JAMIE CHUNG FOR BLOOMBERG BUSINESSWEEK; RIGHT: PHOTOGRAPHS BY DAVIES + STARR FOR BLOOMBERG BUSINESSWEEK (5)

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Economist Farmer says the Fed can act as a giant trampoline for the S&P 500



How Do You Stave Off a Slump? Have Uncle Sam Play the Market

A startling way for softening the next big economic blow

By Peter Coy

A year ago, I wrote a short article for this magazine about an economist with an idea that sounded crazy. Roger E.A. Farmer, a macroeconomist at the University of California, Los Angeles, argued that the government should buy stocks on a massive scale whenever there's a big drop in the market in order to restore the public's confidence and prevent a deep economic downturn. "I get a lot of interest from other economists," Farmer told me, "but it takes a long while for new ideas to spread."

It turns out that Farmer is up to something even more audacious than he explained at the time. He has a bold new theory of how the economy works and doesn't work, explaining persistent unemployment in a way that defies both the new Keynesians on the Left and the so-called new classical economists on the Right. If he's correct, then *How the Economy Works* is a very important book.

Farmer can't be dismissed as a fringe character.

How the Economy Works: Confidence, Crashes and Self-Fulfilling Prophecies
By Roger E.A. Farmer
OXFORD UNIVERSITY PRESS; 208 pp.; $22.95



He is a fellow of the prestigious Econometric Society and has consulted for the Bank of England, the European Central Bank, and the Federal Reserve Bank of Atlanta. The British-born Farmer shares some of the ideas of economist John Maynard Keynes, who explained the Great Depression as a self-reinforcing slump in demand. Like Keynes, Farmer argues that confidence plays a crucial role in keeping the economy operating at full capacity. He says the new Keynesians who occupy important positions in academia, starting with the late Nobel winner Paul A. Samuelson, lost that essential insight about confidence when they tried to jam Keynes' theories into the framework of classical economics. In doing so, they built a theory that could not account for persistently high unemployment.

Farmer isn't a pure Keynesian, though. He admires the new classical economists such as the University of Chicago's Robert E. Lucas Jr., whose belief that markets are governed by rational behavior goes back to pre-Keynesian times. Like this cohort, Farmer says he "grew to believe that fiscal policy may not be the right remedy" for recessions.

The core of *How the Economy Works* deals with Farmer's theory for why unemployment persists. There is no well-functioning market for matching unemployed people with jobs. Ideally there would

ILLUSTRATION BY ALEX NABAUM

be special employment agencies that coordinate the market. These hypothetical agencies would pay job seekers and employers for listing exclusively with them and then get paid for making successful matches. Such agencies don't exist because people, unlike wheat, can refuse to be matched if they don't like the buyer.

Unfortunately this is Farmer's most difficult chapter to understand. He acknowledges that "after 12 rewrites, it still retains an aura of impenetrability." After reading it several times and still not fully understanding some parts, I called Farmer and got him to explain it to me—something most readers won't be able to do.

Strange things happen in the absence of a well-functioning labor market, Farmer says. Even when there are lots of unemployed workers, employers don't get any price signal telling them to divert resources to their HR departments and increase hiring. So unemployment stays high. Of course, employers won't hire if there's no demand—but there will be demand if everyone's working. Farmer's point is that any given level of joblessness, low or high, can be stable and persistent. And the best way to sustain a low-unemployment equilibrium is to use the Federal Reserve as a giant trampoline for the Standard & Poor's 500-stock index.

"The only thing that keeps the economy on track is the collective confidence of hundreds of millions of investors that the economy is sound," writes Farmer. "But as experience has shown, investors are sometimes like buffalo grazing close to a cliff: Once a stampede starts in the wrong direction, it becomes a self-fulfilling prophecy that can be very hard to stop." As Farmer sees it, the Fed would announce a target price path for stock indexes and commit to buying shares in a broad-based index fund until it achieved that goal. If stock prices exceeded the Fed's target, it would sell shares. The stock market would be tamed.

How does the government know when stock prices are too low or too high? Might stock purchases convince investors that the government was pouring taxpayer money down a Wall Street rat hole? Farmer neglects these questions. On the other hand, the status quo has not been a huge success. As the U.S. economy emerges from the recession, fresh thinking on how to prevent or at least soften the blow of the next big bust is needed. In the morass of me-too books about the financial crisis, *How the Economy Works* stands out as a truly big idea. If only it were expressed more clearly. B

Market Watchdogs

Conspiracy theorists say a government entity has already been buying stocks to prop up the market. Some purported evidence:



1989:

Former Federal Reserve Governor Robert Heller tells a San Francisco audience that to stabilize stocks, "The Fed could buy the broad market composites in the futures market." He's speaking hypothetically.



2001:

ABC correspondent and former Clinton Administration official George Stephanopoulos speaks vaguely on *Good Morning America* about government plans to come to the rescue "if the markets start to fall."



2010:

TrimTabs Investment Research CEO Charles Biderman speculates that shares bought by the Fed and other parts of the government caused the market's strong rebound from its March 2009 lows, with the caveat, "we have no way of proving this."

STEPHANOPOULOS: HEIDI GUTMAN/GETTY IMAGES

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Etc. Hard Choices

Richard D. Parsons

"So everyone said, 'You're it.' You don't abandon the team when they need you."

The former Time Warner CEO reflects on his decision to become chairman of Citigroup during the financial crisis



There had to be a chairman at Citigroup. My hope was that Bob Rubin would step forward because he knew the business and he knew all the relevant players. The new government was pretty much in place–and they were all Bob Rubin acolytes. Bob just didn't want to go there, though.

We initially pressed Win Bischoff to do it, but it became reasonably clear as time went on that because Win was also an executive of the company, it compromised his independence. The only other person who really knew the banking business and knew the incoming cast of characters in the government was me. I was the lead outside director and I was one of the long-standing directors. So everyone said: 'You're it.' You don't abandon the team when they need you.

I used to run a bank in the late '80s and '90s, and I became CEO just when the housing boom was touching bottom. When you're in the kind of shape that Citi was in, you have only two friends: One is time, and the other is earnings. We had to play for time and figure out how to get the bank back on the path of earnings growth as quickly as possible.

The toughest part of this job was to trying to help management get their arms around this thing without overstepping the bounds of the non-executive chair. If you're used to running things, you want to step in, but that's not what I am supposed to do. We recruited a bunch of terrific new board members. That wasn't easy. They wanted to know: "Is this thing going to make it? What's my exposure? Why would I want to invite myself to a food fight between Citi and the government?"

There's still a sense of resentment out there. It will get better as the economy gets better. When everyone is doing O.K., there's more tolerance for the people who are doing super-duper O.K. There's been a growing split in this country between the top and the bottom. At some point, it breaks. It's not sustainable. I think the boat is clearly lifting, but we have a long way to go.

—As told to Diane Brady

CHESTER HIGGINS JR/THE NEW YORK TIMES/REDUX

Power your planet.

We live on a planet where nearly 6 terabytes of information are being exchanged over the Internet every second, and where billions of connected people are surpassed in number, only by trillions of connected objects and devices. Why then is the average server in the average business running at only 10% utilization? It's hard enough for businesses to meet the demands of a smarter planet today, much less the unforeseen demands of tomorrow. The new POWER7 Systems™ from IBM are not simply servers—they're fully integrated systems with the ability to run hundreds of virtual servers, helping you drive up to 90% utilization. These next-generation systems integrate massive parallel processing, throughput computing and analytics capabilities to optimize for the complex workloads of an increasingly data-driven world. Learn how to power your planet at ibm.com/poweryourplanet

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